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U.S. ECONOMIC RELATIONS WITH JAPAN

HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

THE IMPACT OF THE YEN-DOLLAR EXCHANGE RATE

APRIL 7, 1983

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U.S. ECONOMIC RELATIONS WITH JAPAN

THURSDAY, APRIL 7, 1983

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room SD–419, Dirksen Senate Office Building, Hon. Charles H. Percy (chairman of the committee) presiding.

Present: Senators Percy, Pell, and Helms.

The CHAIRMAN. I would like to first announce that I must excuse myself from the chair at 11:30 for 20 minutes. The Minister of Energy of Canada is coming in to discuss natural gas prices, and that so vitally affects the entire Midwest and all gas-consuming States and all industry. If there is no one here to preside, we will then recess the hearing for about 20 minutes.

Other than that, I want to welcome our distinguished guests this morning and indicate that this hearing today of the full committee continues a series of hearings that we have had on United States-Japan economic relations. Our current session focuses on the causes, consequences, and possible solutions concerning the problems posed for the United States by the exchange rate between the United States dollar and the Japanese yen.

This issue is not just a matter of academic interest. The value of the dollar in other currencies determines our export sales. In turn, it has a major effect on the millions of Americans whose jobs depend on the United States ability to compete with Japan for markets at home and abroad.

Lee Morgan, chairman of Caterpillar Tractor Co. and one of our witnesses today, has said that the yen-dollar issue "is the single most important bilateral problem confronting the United States and Japan today."

And certainly in the very candid talks that we had during Prime Minister Nakasone's visit to the United States we found him very anxious to get to the very bottom of some of the long-range problems that the United States and Japan have. He is a good problem solver by nature, and we approached this issue in the spirit of working it out with Japan, a strong friend, a strong ally, the second most powerful economic nation on Earth—we being still first. But we must find ways that we can live together, work together, and prosper together.

We know that the fate of our two countries is bound together so that when one of our most prominent industrialists in the United States appears speaking on behalf of one of the most respected groups of businessman in the United States, the Busines Roundtable, and

says that this is the single most important bilateral problem facing the United States and Japan today, certainly it is worthy that we have a full session today on this particular subject.

There is good reason for the concern expressed by Lee Morgan. From 1978 until 1982, the dollar rose by over 50 percent in value against the yen, reaching a high of 277 yen to the dollar in November 1982, while U.S. inflation exceeded Japanese inflation by 20 percent. The two factors have resulted in a severe deterioration in U.S. international price competitiveness against Japan, and have been held responsible for the growth in the size of the United States-Japanese trade deficit: $8.6 billion in 1979, $10.4 billion in 1980, $15.8 billion in 1981, and $17 billion last year.

The currency differential has also been a key element fostering growing American interest in protectionist trade policies and legislation, a matter of grave concern to Japan and certainly something that all of us who have believed in freer trade, as I have all through my industrial life and all through my public life, would want to ward off.

Although the yen now stands at about 240 to the dollar, significantly below last year's high point, the concern still remains that for whatever reason, the Japanese yen is undervalued relative to the dollar.

The suspected yen-dollar misalignment has been particularly difficult to analyze because experts disagree strongly about its causes and effects. One group argues that Japan has taken deliberate actions over the years to keep the Japanese yen low in value relative to the currencies of its major international competitors, particularly in the United States. Others argue that the real problem is high U.S. budget deficits and tight monetary policy, which make the dollar overvalued, not just against the yen, but against other currencies as well.

Still a third group claims that the real difficulty is the failure of the major economic powers to coordinate their economic policies. This lapse has led to conflicting United States and Japanese approaches to controlling inflation, resulting in the exchange rate differentials we see today.

To get to the bottom of this issue, last fall I sent a letter together with Senator Pell to Comptroller General Charles Bowsher. We asked that the General Accounting Office [GAO] conduct a thorough study of the yen-dollar relationship and take a particularly close look at charges that Japanese Government policies have influenced the yen-dollar relationship to Japan's advantage.

I know that the GAO staff has devoted a major effort to this study over the past several months and they are now prepared to offer their preliminary findings to us today. I would caution that these results remain preliminary and could be subject to change upon further investigation, and I am very grateful that GAO has suspended its operation at this point and said here, as of this moment, are some of the preliminary conclusions we have come to, but they are still subject to full investigation. And I presume, Mr. Conahan, you will follow the usual GAO practice of submitting your findings for comment to inform parties so that you can have back the benefit of their rebuttal to your report before a final report is issued. Is that correct?

Mr. CONAHAN. Yes, sir. You can be assured that that will occur.

The CHAIRMAN. Fine. Thank you very much.

After hearing from Frank Conahan, director of GAO's International Division, about the findings of the study, we will then hear from a panel of eminent private sector witnesses for their views regarding the yen-dollar problem and what we might be able to do to redress the imbalance.

We are indeed fortunate to have with us today Lee Morgan, chairman and chief executive officer of Caterpillar Tractor Co.; John Mathis, vice president for international economics, Continental Illinois Bank; Fred Bergsten, director, Institute for International Economics, Washington, D.C.

Mr. Conahan, if you would be good enough to summarize your statement, if possible, could you do it in 10 minutes or so?

Mr. CONAHAN. Yes, sir.

The CHAIRMAN. All right, fine. The full text of your prepared testimony will be placed in the record. I have read the full text and I appreciate your sending it up last night so that we could study it. Our plan is to hear and question you first regarding the GAO study; then we will hear and question our distinguished panel of private sector witnesses.

STATEMENT OF FRANK C. CONAHAN, DIRECTOR, INTERNATIONAL DIVISION, GENERAL ACCOUNTING OFFICE [GAO], ACCOMPANIED BY ALLAN MENDELOWITZ, ASSOCIATE DIRECTOR, INTERNATIONAL DIVISION, GAO

Mr. CONAHAN. Thank you, Mr. Chairman. With me today is Allan Mendelowitz, who is an Associate Director in the International Division of GAO. We indeed are happy to testify today at your request on the issues raised by recent changes in the value of the dollar on foreign exchange markets in general, and by the recent changes in the exchange rate between the American dollar and the Japanese yen specifically.

As you mentioned, these changes influence our international trade, production, employment, and inflation, thus affecting our overall economic health.

I would like to emphasize that these are our preliminary conclusions, and we expect to render a final report to this committee some time this fall.

The exchange rate between the dollar and the Japanese yen has received considerable attention, as you mentioned. Concerns that this rate has not reflected fundamental economic factors have generated charges that Japan manipulates the exchange rate of its currency to gain an unfair trade advantage. These charges have added to the tensions with Japan over other trade issues, as you also mentioned, Mr. Chairman.

This concern over the yen-dollar exchange rate also comes at a time when many observers are raising questions about how well flexible exchange rates and the current international monetary system are working. Ten years ago when the system was adopted, two widely held beliefs were that flexible exchange rates would avoid sustained inappropriate currency values and domestic economic policy formulation would be freed from the burden of international payments considerations. These propositions are being questioned today.

Although our work on all of these issues is continuing, we have reached several preliminary conclusions. First, exchange rates in general cannot be adequately explained by looking only at international trade or specific bilateral relationships. Many variables, including the balance of trade, capital flows, and differences between countries' national economic policies and economic conditions, affect exchange rates. Unmeasurable factors, such as perceived political risks and expectations, also play a critical role.

A consequence of these complex determinants is that foreign exchange markets can yield exchange rates that have adverse trade and employment consequences for us and for other nations at particular times.

Second, looking particularly at the yen-dollar exchange rate, we have seen no evidence to support charges that the Japanese Government manipulated or artificially depressed the value of the yen. On the contrary, Japanese foreign exchange intervention, together with other actions during this recent period, would tend to have strengthened, rather than weakened, the yen.

The yen-dollar exchange rate at least partly reflects differences in the economic policies pursued by the United States and Japan during the period. High real interest rates in the United States partly explain the dollar's strength against the yen and other currencies. High return on investments proved attractive to foreign investors. The persistent strength of the dollar, despite the high U.S. merchandise trade deficits noted earlier, indicates the importance of this factor.

The decline in the U.S. inflation rate also contributed to the dollar's strength, particularly since the decline has been faster than many observers anticipated. If the generally expected rate of inflation remains low, this would continue to contribute to the dollar's strength.

Another possible but partial explanation of the yen-dollar rate is the opportunity that Japanese investors took to diversify their portfolios when capital controls were relaxed. In 1981 and 1982 net outflows of capital from Japan were $7.4 billion and $15.7 billion, respectively. Since Japan's savings exceed its demand for savings, net Japanese capital outflows were consistent with underlying economic conditions.

A third tentative conclusion is that as international trade and investment have become much more important to the United States over the past decade, domestic economic policies and exchange rates have become more dependent on each other. Domestic economic policy decisions affect exchange rates. At the same time, changes in exchange rates affect policies' success in reaching goals, such as high employment or low inflation.

Contrary to expectations, flexible exchange rates do not allow countries to pursue independent economic policies without considering the international consequences.

Finally, although currency fluctuations have created genuine problems and some observers have called for modifying the floating exchange rate system, there is no consensus as to whether changes would be desirable, and no agreement on what would constitute a better system.

Where a consensus does lie is in the recognition that domestic policy options in an open economy are more constrained than in a closed economy. Implementation of domestic economic policy without explicit

recognition of the international constraints and costs of policies can be very disruptive to exchange markets and in turn, can prove costly to the economy.

Mr. Chairman, that concludes our summary. We will be happy to take your questions.

[Mr. Conahan's prepared statement follows:]

PREPARED STATEMENT OF FRANK C. CONAHAN

Mr. Chairman and Members of the Committee: We are happy to testify today, at your request, on the issues raised by recent changes in the value of the dollar on foreign exchange markets in general and by the recent changes in the exchange rate between the American dollar and the Japanese yen. These changes can influence our international trade, production, employment and inflation, thus affecting our overall economic health. Our comments today represent an interim report on our ongoing work in this area.

The exchange rate between the dollar and the Japanese yen has received considerable attention in recent months. Concerns that this rate has not reflected fundamental economic factors have generated charges that Japan manipulates the exchange rate of its currency to gain an unfair trade advantage. These charges have added to the tensions with Japan over other trade issues.

This concern over the yen-dollar exchange rate also comes at a time when many observers are raising questions about how well flexible exchange rates and the current international monetary system are working. Ten years ago, when the system was adopted, two widely held beliefs were that (1) flexible exchange rates would avoid sustained inappropriate currency values and (2) domestic economic policy formulation would be freed from the burden of international payments considerations. These propositions are being questioned today.

Although our work on these issues is continuing, we have reached several preliminary conclusions:

First, exchange rates in general cannot be adequately explained by looking only at international trade or specific bilateral relationships. Many variables, including the balance of trade, capital flows, and differences between countries' national economic policies and economic conditions, affect exchange rates. Unmeasurable factors, such as perceived political risks and expectations, also play a critical role. A consequence of these complex determinants is that foreign exchange markets can yield exchange rates that have adverse trade and employment consequences for us or for other nations at particular times.

Second, looking particularly at the yen-dollar exchange rate, we have seen no evidence to support charges that the Japanese Government manipulated or artificially depressed the value of the yen. On the contrary, Japanese foreign exchange intervention, together with other actions during this recent period, would tend to have strengthened rather than weakened the yen.

Third, as international trade and investment have become much more important to the United States over the past decade, domestic economic policies and exchange rates have become more dependent on each other. Domestic economic policy decisions affect exchange rates. At the same time, changes in exchange rates affect the policy's success in reaching goals, such as high employment or low inflation. Contrary to expectations, flexible exchange rates do not allow countries to pursue independent economic policies without considering the international consequences.

Finally, although currency fluctuations have created genuine problems and some observers have called for modifying the floating exchange rate system, there is no consensus as to whether changes would be desirable and no agreement on what would constitute a better system.

I will discuss each of these points in greater detail, starting with the issue of exchange rate determination. My testimony will focus on events between 1980 and today, although I will make some references to policies and economic conditions that prevailed during the 1970's.

EXCHANGE RATE DETERMINATION

The world's economies are linked by substantial international trade and capital flows. Some system is required to adapt to changes among these economies that occur over time. Under flexible exchange rates, currency values

change to accommodate the differences. Any variable that changes the relative economic condition of a country will affect the exchange rate of its currency. Although it seems that this would produce an endless list of variables to watch, market participants and researchers point to some fairly basic ones, including: Relative price levels; relative interest rates; relative income levels and money supplies; relative trade and investment flows; political risk, such as risk of government-directed economic changes or exchange controls; and expectations of changes in all these variables.

Most of these determinants are strongly influenced by economic policies and each other, which further complicates explaining or forecasting exchange rate movements.

Further, it is impossible to look at one exchange rate in isolation from all others, since foreign exchange markets are so closely tied together. The dollar is the basic currency of the flexible exchange rate system. Its value with respect to any one currency must be in line with its value with respect to all other currencies. This fact points out the limitations of looking only at trade flows between two nations to explain the exchange rate between their currencies.

Furthermore, market observers generally agree that expectations of future events and policies play at least as important a role in determining exchange rates as does the current situation. As a result, the foreign exchange market is extremely sensitive to news that alters expectations. The prompt reaction of foreign exchange markets to "news" explains to a great extent why exchange rates are so hard to forecast, particularly in the short term. Nevertheless, several useful conclusions do emerge from the analysis of the determinants of exchange rates.

Analyses that look only at bilateral trade balances or the relative price levels or inflation rates of two nations are overly simplistic and invalid. Relative inflation rates of two nations may set a long-term trend for changes in the exchange rate between their currencies, but the daily figure, or a weekly, quarterly or even annual average exchange rate will diverge significantly from the basic trend line.

Market experts do not see government intervention as a way to affect the long-run value of a currency. There is disagreement about intervention designed to moderate exchange rate fluctuations without changing the fundamental direction of the currency's value. Advocates of such intervention argue that it can lessen the uncertainty and adverse trade effects associated with floating exchange rate changes, while opponents counter that such intervention cannot succeed. Foreign exchange market responses to expectations of a government's intention and mistakes in timing the intervention could prevent it from having the expected result.

THE YEN-DOLLAR RELATIONSHIP

As I mentioned earlier, the yen-dollar exchange rate has been the focus of substantial attention. Much of this attention reflects the underlying tension in U.S. trade and economic relations with Japan.

During the latter part of 1982, the value of the dollar rose considerably in relation to the Japanese yen, reaching a high point in early November, when it was worth ¥278. Between January 1979 and November 1982, as shown in Chart 1, the yen fell 34.1 percent in nominal terms relative to the dollar. Adjusting for the differences in the national inflation rates, we see that the yen depreciated 37.9 percent in real terms. Other analysts have chosen different base periods for the comparison, but the conclusion is unchanged—the dollar appreciated substantially against the yen.

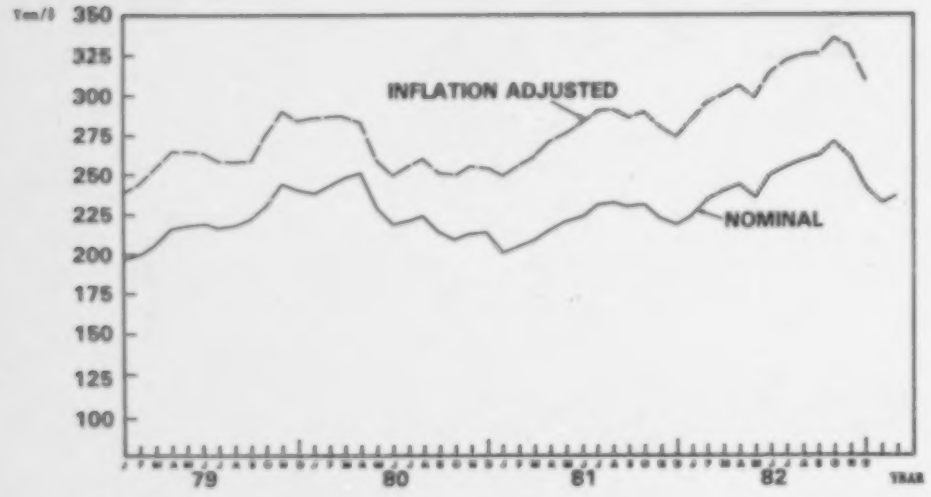
Bypassing for the moment the question of how the yen-dollar exchange rate got to such a level, let's ask if the rise in the dollar relative to the yen was unique. The answer is no. As chart 2 shows, over the same January 1979 to November 1982 period when the yen fell by 34.1 percent, the British pound fell 22.8 percent, the West German mark fell 38.3 percent, and the Swiss franc fell 31.4 percent.

Adjusting for differences in national inflation rates, we see the same pattern. The yen fell by 37.9 percent, the pound by 8.9 percent, the mark by 45.0 percent, and the Swiss franc by 51.0 percent. Choosing a different base period for comparison would not materially change the rankings of the currency depreciation rates against the dollar; the dollar appreciated against many major currencies, not just the yen. The rate at which the dollar appreciated against the yen was not unusual.

From the low of ¥278 to the dollar, the yen has appreciated 15 percent and was ¥236 last week. Other currencies have similarly adjusted in value, suggesting that the dollar "overshot" its equilibrium value in late 1982. Such overshooting has sometimes been explained as a result of exchange rates reacting faster to financial variables than to real or merchandise flows between countries.

CHART 1

YEN-DOLLAR EXCHANGE RATE JANUARY 1979 TO FEBRUARY 1983

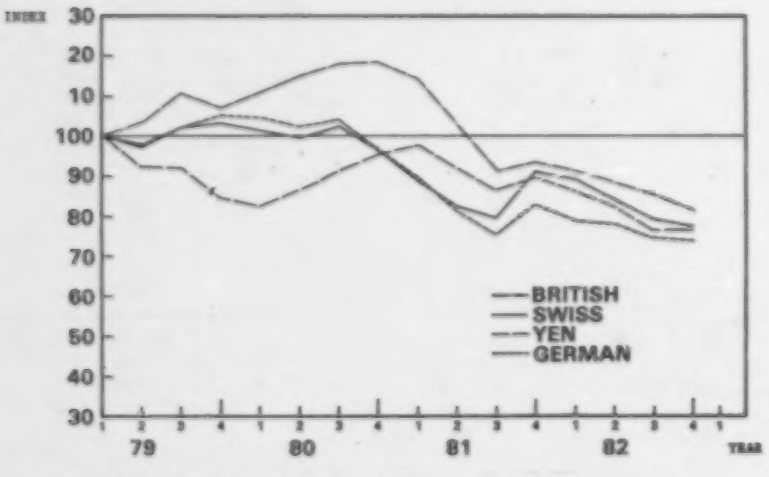


INDEX FOR INFLATION ADJUSTMENT: 1975=100

CHART 2

RELATIVE CHANGES IN EXCHANGE RATES FOR THE DOLLAR

(FIRST QUARTER 1979 EXCHANGE RATE = 100)



INDEX MEASURES: U.S. DOLLARS PER UNIT OF FOREIGN CURRENCY

Overall tension in United States-Japan economic relations better explains the attention given the yen-dollar exchange rate than structural problems in the yen-dollar rate. The U.S. merchandise trade account with Japan shows that we import more than we export. This deficit with Japan has become a regular feature of U.S. international trade patterns, amounting to nearly $16 billion in 1981 and $17 billion in 1982. The bilateral trade deficit has persisted during periods of low and high exchange rates between the yen and the dollar. This negative trade balance with Japan contrasts dramatically with the positive trade balance we have with the European Community as a group, which totaled $22.9 billion in 1981 and $16.9 billion in 1982. These relative trade patterns explain, in part, the emphasis upon the yen-dollar exchange rate despite similar appreciation of the U.S. dollar against European currencies.

The persistent merchandise trade deficit with Japan and relatively higher American inflation during 1979 to 1982 seem inconsistent with the strength of the U.S. dollar. Holding all else constant, a persistent deficit and the higher U.S. inflation should have weakened the dollar. Thus, the yen's depreciation was greeted quizzically by American businessmen, some of whom argued that the Japanese Government had to be "rigging" the value of the yen. Although a government could attempt to do this through central bank intervention, it would result in an increase in official foreign exchange reserves. This did not happen between January 1982 and January 1983, when Japan's reserves decreased by $5.2 billion, indicating that Japan was supporting rather than depressing the yen's value during this period. Additionally, to maintain a consistently undervalued currency during the 1973–82 period, the Bank of Japan would have had to purchase "exceptional" amounts of other currencies. Our analysis suggests that Japan's reserves did not grow at exceptional rates over the 1973–82 period but were generally consistent with reserves in other industrial nations.

The yen-dollar exchange rate at least partly reflects differences in the economic policies pursued by the United States and Japan during this period. Our analysis is not yet complete, but we have identified several factors which have affected the yen-dollar exchange rate.

High real interest rates in the United States partly explain the dollar's strength against the yen and other currencies. High return on investments proved attractive to foreign investors. The persistent strength of the dollar despite the high U.S. merchandise trade deficits noted earlier indicates the importance of this factor.

The decline in the U.S. inflation rate also contributed to the dollar's strength, particularly since the decline has been faster than many observers anticipated. If the generally expected rate of inflation remains low, this also may contribute to the dollar's strength.

Another possible and partial explanation of the yen-dollar rate is the opportunity that Japanese investors took to diversify their portfolios when capital controls were relaxed. In 1981 and 1982, net outflows of capital from Japan were $7.4 billion and $15.7 billion, respectively. Many of Japan's capital controls were relaxed administratively during the 1970's or by the Foreign Exchange and Foreign Trade Control Law in 1980. Since Japan's savings exceeded its demand for savings (composed of investment and the government deficit), net Japanese capital outflows were consistent with underlying economic conditions.

Aside from the Japanese central bank's intervention in foreign currency markets mentioned earlier, Japan has taken other measures to support the yen's value. A relaxation of monetary policy was delayed during this period because of the weak yen. In addition, despite the trend toward liberalizing capital markets, Japan attempted to discourage capital outflows by administrative guidance. These actions appear consistent with the 1970's policies of moderating fluctuations in the yen's value on exchange markets. This type of intervention is envisioned in the International Monetary Fund's Articles of Agreement.

Several other factors have put downward pressure on the yen. At the beginning of 1982, many forecasters projected that Japan's current account would have a surplus of $15 billion to $20 billion for 1982; the actual surplus was $6.9 billion. Essentially, the foreign exchange market reacted against the yen since the Japanese current account was not as strong as everyone expected. The yen-dollar exchange rate in early 1982 was based in part on these expectations; the rate later in 1982 reacted to news that the earlier expectations were unrealistic. Additionally, persistent threats of protectionist restraints on Japanese exports may have put further downward pressure on the yen.

Other factors which cannot be overlooked when considering strength of the dollar vis-a-vis the yen and other currencies are the political and world economic uncertainties during this period. Traditionally, the United States attracts many overseas investors who are looking for a place safe from political and economic turbulence. Debt problems in Eastern Europe and Latin America increased the uncertainty in the international monetary system as did the overall political uncertainty and tension of 1982.

OBSERVATIONS ON THE FLEXIBLE EXCHANGE RATE SYSTEM

The recent history of flexible exchange rates and macroeconomic policy in economies open to the rest of the world demonstrates the close ties now existing between international and domestic economic conditions. The U.S. economy and its performance in the post-war era have had substantial impact on foreign economies because of its dominant size and the importance of the dollar in world finance. The world economy now has a more important influence on the U.S. economy as well. In addition, the shift to floating exchange rates has influenced how the world economy affects the United States.

A number of the problems popularly attributed to floating exchange rates are in reality the consequences of the United States being an open economy with internationally integrated goods and capital markets. American exporters are affected by economic conditions in other nations, not just by economic conditions at home. American investors seek overseas investment opportunities. Likewise, overseas investors are attracted by opportunities here. This openness removes any opportunity that may have once existed to insulate the United States from international economic changes.

However, these influences are not evenly distributed over the economy. Some industries deal in products that are extensively traded internationally, while other industries are relatively insulated from world trade. Housing construction is an obvious example of an industry not tightly connected to world trade so it does not react substantially to exchange rate fluctuations. Other industries that compete in world markets can be severely affected.

If we were to rank American industries by their international competitiveness some industries obviously would be at the top of the list and able to sell internationally at most exchange rates. Industries at the bottom of the list operate at severe cost disadvantages relative to foreign producers. At any plausible exchange rate, American consumers would be able to buy cheaper goods from overseas producers. Industries in the middle of the list may or may not be competitive in foreign markets, depending on prevailing exchange rates. When the dollar is strong, these industries will find themselves priced out of international markets. This was the case during 1982. During 1978 and 1979, conversely, the weak dollar enabled these industries to be more competitive in foreign markets.

Since it helps determine international trade, a floating exchange rate can influence the results of national macroeconomic policy. The United States, for example, has relied on a tight monetary policy, that by itself, would cause a decline in economic activity. But since the tight money contributed to the strength of the dollar, this effect apparently was amplified. Imports became cheaper and U.S. exports more expensive, leading to further reduced industrial output and employment. The influence of exchange rates on the success of macroeconomic policy is unavoidable in an open economy with flexible exchange rates.

The persistence of the strong dollar and the worldwide recession have led to a number of suggestions to modify the international monetary system to lessen exchange rate fluctuations or reduce the sensitivity of economies to international economic disturbances.

While the desire to alleviate the problems thought to be caused by flexible exchange rates is understandable, there is no consensus supporting either the need for change or specific types of changes to make.

Reform proposals are not free from some of the very problems of floating exchange rates or have limitations of their own. For example, the idea of adopting target zones within which currencies would be permitted to fluctuate, as one proposal suggests, is limited by the problems inherent in fixing the target and deciding when it should be changed. Should the target be pegged to national prices or should interest rate differentials be considered? Should the peg change monthly, weekly, or quarterly? If the rules for setting the target are not public knowledge, there can be substantial uncertainty about possible changes in the target. This uncertainty parallels the uncertainty of forecasting a floating exchange rate. If the rate-setting rules are announced, however, there is some

possibility that this could form the basis for speculative behavior and major currency moves could be either accelerated or delayed depending on anticipated rule changes. We do not know at this stage whether this speculation would be stabilizing or destabilizing. This situation should be contrasted with the consensus that did exist 10 years ago concerning the deficiencies of the Bretton Woods System and the need for major changes.

Where a consensus does lie is in the recognition that domestic policy options in an open economy are more constrained than in a closed economy. Implementation of domestic economic policy without explicit recognition of the international constraints and costs of policies can be very disruptive to exchange markets and, in turn, can prove costly to the economy.

Mr. Chairman, this concludes my prepared statement. I will be happy to answer any questions you or your committee may have.

The CHAIRMAN. Thank you very much. I was pleased that you did emphasize that there was no finding that there was Japanese Government manipulation. I have not ever used that word. I have not heard responsible business people use that word. The wording that I did use, however, in my letter to the Comptroller General was whether or not Japanese Government policies have influenced the yen-dollar relationship, and the influences can be all types of things.

The question is whether or not we can identify those things that have influenced it. There are Japanese business people who realize that the relationship between the dollar and the yen is today an extraordinarily difficult thing on which we can build a truly longlasting, sound foundation for our bilateral trading relationship.

Have you made any finding yet as to whether there are influences—things that the Japanese Government could do, that MITI could do—that would help correct this situation, not using at all the word "manipulation," which was not intended by my question or statement in the way I phrased it?

Mr. CONAHAN. I think that any economic activity undertaken by either government influences one way or the other the exchange rate. I don't think we have been able to single out any one activity undertaken by either Japan or the United States that has influenced the exchange rate in the manner in which you are speaking.

Certainly any action, for example, to reduce the interest rate in the United States would impact ultimately on the exchange rate. So I think that we can, in the final analysis, point to those things which have had some impact on the exchange rate. But in terms of specific actions to manipulate, and we use that word because it was in the lexicon of debate over this very issue, we wanted to back away from any conclusion on that.

The CHAIRMAN. Yes. But would you say that there may be the possibility that Japan's other economic and monetary policies might inadvertently keep the yen low in value as against the dollar and other currencies as well?

Mr. CONAHAN. Well, all currencies are involved. Mr. Mendelowitz?

Mr. MENDELOWITZ. The Japanese economy, over the past decade, has become increasingly subject to freer markets and reduced direct government control. If you look at the history of policy in Japan in the 1950's and 1960's, you have an economy with substantial government direction of economic activity. Foreign exchange was strictly controlled and allocated by a Foreign Exchange Control Board. The government maintained very strong control over the flow of capital and engaged in capital rationing.

Over the past decade, under the influence of both the United States and the growth and increased health of the Japanese economy, there has been a very substantial liberalization in the Japanese economy. It has not reached the point yet where I would say that United States exporters are completely satisfied, but it is certainly an improvement over what it was earlier, and there is momentum.

With respect to capital controls over the past decade, first administratively and then through the Foreign Exchange and Foreign Trade Control Law of 1979, the Japanese Government removed most of the restrictions on the inflow and outflow of capital to Japan. As a result, the Japanese investors had, for the first time, greater opportunities to diversify their portfolios and invest overseas. This led to very substantial outflows from Japan when investment opportunities overseas were particularly ripe.

So in the 19 months prior to November of 1982 when the yen reached its lowest value in recent years, there was a constant outflow of capital from Japan in pursuit of higher interest rates in the United States and other places. This massive movement of capital would tend to depreciate the value of the yen.

So I guess you could say that the liberalization of capital controls in Japan did contribute to a decline in the value of the yen.

Now what we have here is a balancing of two policy objectives. On the one hand, there was a strong interest in seeing the yen increase in value because when it hit 278 to the dollar in November of 1982, there was universal agreement that it was much too low in value.

But at the same time, we have an interest I think in seeing trade barriers and investment barriers removed around the world. I would be reluctant to say that a desirable alternative at this point would be to ask the Japanese Government to reverse liberalization in the capital markets and reimpose controls. You might get some strengthening of the yen in the short run, but we would see a regression or a reversal of a policy that I think in the long run we would consider very desirable.

The CHAIRMAN. What are the kinds of things that the Japanese Government can do that are under its control? They do control obviously the level of imports. I have said this on this podium before, many times, speaking directly to our friends in Japan. I established a factory and did business in Japan myself and had a plant of 1,000 people there, which helped create more employment in this country. It was a fine partnership over a period of years. But it is a restricted society from the standpoint of investment. We had to work very closely with MITI, and they do limit imports severely. Some agricultural products particularly are limited, and that is where we have tremendous productivity, the highest productivity in the world, the lowest prices, and yet we are restricted in what we can ship in.

What influence would it have on the dollar-yen relationship if more restrictions—and already 56 restrictions have been lightened somewhat by the Japanese Government and they are continuing to work in this area—what would happen if they continued to open up more markets inside Japan? How would this relationship be affected by that?

Mr. MENDELOWITZ. There are a number of highly visible trade disputes with Japan—certain agricultural commodities, certain other things. Some of the disputes are caused by official government quotas

or other restrictions, such as tariffs. Other disputes are the result of the fact that we do business differently than the Japanese do.

There have not been very many studies as to how much more the United States would sell in Japan if all these trade barriers were removed. We don't give much credence to the few studies that we have seen, because methodologically they were quite flawed. But with that caveat, they did not indicate that very large amounts of trade were involved.

But were additional trade measures taken that would increase the flow of U.S. exports to Japan, that would increase the supply of yen in the world market and it would increase the demand for foreign currency, which in itself would tend to depress the value of the yen rather than strengthen it.

The CHAIRMAN. Let us come back then to something the United States can do and get your views on the effect that U.S. interest rates have had. Some have said that it is one of the primary causes of the dollar-yen misalignment. Others think it is just one factor involved.

As we reduce our interest costs here, will that then help correct the situation?

Mr. CONAHAN. I think the high interest rates undoubtedly have been a very important factor in the alignment between the yen and the dollar, and if all else stood pat, a reduction in those interest rates I think would help. But I think we need to consider the gamut of economic factors in trying to answer that question and I think this country has to take a look at the whole gamut of those economic factors.

The CHAIRMAN. Is there any indication—because this has to be now a relationship between interest costs in Japan and interest costs in this country—that there are government policies, for instance in targeted industries where they are extremely anxious to develop a strong position in world markets, that they actually do subsidize interest rates and bring interest rates down somewhat artificially, which then exacerbates the problem of the yen-dollar relationship?

Mr. CONAHAN. That condition has existed for a long time. Clearly there has been a much lower interest rate generally in Japan, as you know, Mr. Chairman, over the years, than there has been in this country. We have seen industries targeted for quite a period of time in Japan as well, given assistance, including subsidized loans.

The CHAIRMAN. What effect also does it have in this long term discussion we have had with our friends in Japan about their paying their fair share of the common defense? This has gone on for a long time. I have had intimate discussions with every prime minister since I have been on this committee, and long before that. They pay less than 1 percent of GNP, against our, say 6 percent, and yet we provide for our common defense. Now they are willing to consider at least reaching out, as Prime Minister Suzuki proposed to reach out 1,000 miles to protect themselves in their own sea lanes and to help out in the Persian Gulf area with development assistance and so forth, which is protecting the oil source which is the heart of the whole economy of Japan.

What if we didn't provide protection in the Persian Gulf, and there was a cutoff of oil there? It could happen. I questioned the Soviets about this directly 2 years ago in the Kremlin and said there are many people in this country who feel that the Soviets move into Afghani-

stan can only be intended to get within 300 miles of the Straits of Hormuz, to threaten the oil supply. And that, as President Carter said, would mean war. But it would more severely impact on Japan than any other country.

What would happen if Japan did decide to step up its expenditures for its own defense and the common defense—increase them a little more rapidly than they are now? Would that have an impact on the yen and the dollar?

Mr. CONAHAN. If the increase were financed through a deficit, I would expect that there would be some impact on the value of the yen. I would think that that would occur.

I would like to add, Mr. Chairman, that I think there are ways that Japan can increase its contributions to the common defense. We in GAO have identified a number of ways that Japan could support U.S. troops in Japan and in the area and contribute to some housekeeping costs which would be helpful in that regard.

So I think that not only would there be an impact, but there are opportunities to do so.

The CHAIRMAN. Have you gone far enough in your study to determine that the yen-dollar misalignment is a temporary phenomenon that will be gradually corrected by market forces? How long will it take, if you have come to that conclusion, and has the exchange rate correction of the past few months been in your judgment really significant?

Mr. CONAHAN. I am not really sure that we have seen a criteria which would permit us to come to a final conclusion in that regard. I think clearly there is agreement that the rate in November was out of line. There has been a 15 percent appreciation since that time. That may simply have been a normal adjustment to its being out of line at that time. Again, it may be something else.

I am not sure, Mr. Chairman, that our study is going to be able to conclude on that particular score. I think perhaps that exchange rate theory needs to be developed a little bit more than it is right now. We just simply have not seen it to date.

The CHAIRMAN. Do you have any personal judgment as to what brought about the sudden change in the value of the yen?

Mr. MENDELOWITZ. There were several events. It was a somewhat delayed response to the decline in interest rates in the United States, a recognition that at 278 to the dollar, the yen was very substantially undervalued, which in turn made investment in Japan especially attractive.

If you were to convert foreign currency into yen at 278 to the dollar and invest in the Japanese stock market, you had the opportunity to gain twice. You could gain from appreciation in the market which took place and then you had a chance to gain from the fact that the value of the yen—the currency the stocks were denominated in—would also increase.

This is essentially what happened when the value of the yen got so substantially out of line. There was a reversal of the net capital flow out of Japan. Capital started flowing in and there was an influx of funds into the Japanese stock markets for portfolio investment. There was a surge in the Japanese stock market and there was a substantial increase in the value of the yen.

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The problem with defining overvalued or undervalued is that when a currency gets very substantially out of line, like the yen did in 1982 or like the dollar did, for example, in 1978, there is a general consensus. You sort of know it is out of line. When you get a currency value in the marketplace that is back toward the reasonable range, given the way in which exchange rates are determined and all the factors that influence exchange rates, there really is no basis for saying any currency is 5 percent overvalued or 5 percent undervalued, because, as we said in our statement, a lot of things determine exchange rates. It is not just the balance of trade, and that is the critical thing to bear in mind.

The exchange rate may have adverse consequences for us with respect to goods trade, but it still may not be undervalued in terms of total demand and supply for the currency and all the factors that go into determining its value.

The CHAIRMAN. I would like to go back in history to 1978, at which time the U.S. Government announced a series of comprehensive measures to stabilize the dollar, which had depreciated substantially against other major currencies. These measures included a rise in the discount rate, increased U.S. gold sales and increased U.S. intervention in the foreign exchange market to support the dollar.

This is really not long ago, but it is hard to even recall that today, under these circumstances, that we faced those conditions back in 1978. Even if the effect of these measures was only psychological, they may have contributed to the subsequent dollar appreciation.

Would a similar abrupt policy change be effective at the present time to deal with the dollar appreciation? If so, what types of measures would seem to be most effective in reducing the value of the dollar relative to the yen?

Mr. CONAHAN. I think, Mr. Chairman, that you have to appreciate that the actions taken in 1978 were very substantial. As you mentioned, there were rather massive interventions in the market and there was domestic economic activity at the same time.

So I think you had a rather substantial set of actions taking place, and you had multilateral cooperation. As I recall, Japan, Germany, and Switzerland were all deeply involved.

Now, if we get something on that scale today and had that sort of multilateral cooperation, I would expect some improvement in the area. But I think all these factors have to be taken into account.

The CHAIRMAN. The issue that the President faced yesterday in his trip to Pittsburgh is jobs. I have said a number of times that the three principal issues in Illinois today are first jobs, second jobs, and third jobs. I have put my time in on unemployment lines and unemployment compensation offices behind the counter just to listen to people, to talk with them, to see what efforts they are making and talk about the frustrations they have in finding jobs.

What we are talking about here in this imbalance that exists between the yen and the dollar are not just thousands of jobs. It is tens of thousands, maybe hundreds of thousands of jobs. It is a crucial issue.

In your testimony you conclude that:

> Implementation of domestic economic policy without explicit recognition of the international constraints and costs can be very disruptive to exchange rates, and in turn can prove costly to the economy.

Is it your judgment that the U.S. Government in adopting anti-inflationary tight money policies has not given enough attention to the international consequences of those policies, and that the result has been the extraordinary rise in the U.S. dollar that has proven so damaging to American exporters and to American jobs?

Mr. CONAHAN. I think that we were not attempting to critique the actions of the administration, but rather to state a fact as we found it. We are trying in the testimony to put forth a set of economic factors that are involved in this whole question, rather than draw conclusions concerning the actions of the administration.

The CHAIRMAN. Thank you.

My final question goes back to the problem faced by Prime Minister Nakasone, the major dilemma that he faces regarding the yen-dollar issue, because it is a dilemma for both countries now. He seems to be committed to the same mix of domestic economic policies that contributed to the weak yen in 1982. That is, fiscal policy will remain tight while the Bank of Japan tries to maintain a relaxed monetary policy.

Do you agree that a continuation of such recent Japanese policies would and could contribute to a weak Japanese yen in 1983, and if continued into future years, would continue the problem?

Mr. MENDELOWITZ. We generally are not in the business of forecasting exchange rates. I make that statement as a caveat before I say anything else. I think what is important is not only what Japan does with respect to monetary and fiscal policy, but what Japan does relative to what other countries do.

It is true that Japan historically has had a commitment to a policy that involved a balanced budget and low interest rates. Over the past few years they have not been able to maintain this policy. They have had very substantial budget deficits and they have had relatively high interest rates, at least real interest rates.

So I think that, first of all, it is unclear how successful Japan in the short run will be in eliminating or reducing in a substantial way their very large budget deficits. So we do not know how that is going to come out.

And then second, as I said in the introduction to the statement, the implications of those policies for the yen really must be considered in concert with policies adopted in the United States and in the Common Market. Now, clearly if the Japanese were to increase their budget deficit, if they were to raise their interest rates, this would have an impact on the yen that would raise its value.

But just as I would not recommend to the U.S. Government that it pursue a mix of monetary and fiscal policy with exclusive consideration of the impact on exchange rates—namely, you have lots of goals you want to achieve with monetary and fiscal policy, and what happens to the exchange rate is one of them—I would be reluctant to advise any country to pursue domestic economic policies that had only exchange rates as the primary objective.

The CHAIRMAN. Do you have anything to add to that, any further comments?

Mr. CONAHAN. That is where our study leads us to at the moment.

The CHAIRMAN. All right, fine. We very much appreciate your being with us. Would you express to the Comptroller General my apprecia-

tion for the speed with which you have come to your preliminary phase. I will watch with great interest for the conclusion of your report.

You are both cordially invited to stay and hear our next panel if you have the time to do so. Thank you.

Mr. CONAHAN. Thank you, Mr. Chairman.

Mr. MENDELOWITZ. Thank you very much.

The CHAIRMAN. Now we are pleased to call our distinguished panel of: Lee Morgan, chairman, Caterpillar Tractor Co., Peoria, Ill.; John Mathis, vice president for International Economics; Continental Illinois Bank; and C. Fred Bergsten, director, Institute for International Economics in Washington.

Mr. Morgan, if you would start off. You are appearing on behalf of the Business Roundtable, is that correct?

STATEMENT OF LEE L. MORGAN, CHAIRMAN, CATERPILLAR TRACTOR CO., PEORIA, ILL.

Mr. MORGAN. Thank you, Mr. Chairman. It is a real pleasure to be here this morning on behalf of not only Caterpillar, but also the Business Roundtable, to discuss the question of the sustained undervaluation of the Japanese yen.

I have a prepared statement that I believe addresses most of the questions that you posed in your letter of invitation, and I would like to ask for its inclusion in the record.

The CHAIRMAN. The full statement will be incorporated in the record.

Mr. MORGAN. Fine, thank you.

As we look at the issue before us, I do not believe it is very constructive to debate whether the Japanese yen has been undervalued relative to the dollar, because I do not hear any credible economists saying that there is not an exchange rate problem. And I can assure you that most businessmen know when an exchange rate problem exists, because their employment numbers and their profits reflect the fact that there is a misalinement and the degree of it.

Unfortunately, however, there is not total agreement on the causes of the yen-dollar misalinement or what to do about it, and I think the previous testimony touched upon that subject in a very useful way. Because of this vacuum, the Business Roundtable undertook to develop a list of suggestions for action by the United States and Japan to address the yen-dollar imbalance, and we offer them today in our full statement to help further this committee's debate on the topic and to stimulate action.

In asking for action, I would remind us all that many Japanese businessmen are expressing as much concern about this problem as we are. Mr. Yamashita, director and chairman of Mitsui Engineering and Shipbuilding Co.—a businessman, like you and me—has said:

> Looking back at the past year, I think we can say that without question one of our most serious problems in Japan has been the misalignment of the dollar and the yen.

This is not an American businessman speaking. This is a Japanese businessman. He said:

> The undervalued yen, added fuel to the flames of international resentment against Japan, worsening our trade relations with the United States and increasing protectionist sentiments.

The reasons include high interest rates in the United States and the lack of investment opportunities in Japan. Of course, all major currencies were affected by the same phenomenon, but the misalignment is more extreme in the case of the yen because the yen is not fully internationalized.

Mr. Yamashita continued in this statement:

This is one reason why we support continued steps to internationalize the yen. It is also important for the United States to take macroeconomic policies that take into account the competitiveness of the U.S. economy in world markets.

He concluded:

In a longer run sense, both our governments need to review the operation of the international monetary and financial systems. The main point is that neither country can correct the present misalignment alone; both must take steps.

Mr. Yamashita stresses precisely the points that U.S. businessmen have been making. We should acknowledge—and again, the previous testimony touched on this point—that the yen has strengthened from its weak point last November of 278 to the dollar. However, viewed over the perspective of the last 4 years, in real terms the yen is still 35 percent weaker than it was in 1978.

During the last four quarters, Japan's exports of goods and services in constant yen grew at a 4.9 percent rate, while those of the United States, France, the United Kingdom, and Germany declined at rates of from 6 to 13 percent. These facts to me argue rather conclusively that the problem cannot be brushed aside as the strength of the U.S. dollar. Rather, the facts point to the weakness of the Japanese yen, and clearly this situation demands action.

The interest rate spread between the United States and Japan is a major factor affecting the relative valuation of the currencies. There is general agreement that, while Japanese savings propensities are an important contributor to this differential, conscious insulation of the yen from worldwide interest rate trends exaggerates that spread. Thus, we recommend policies in both countries to reduce that interest rate differential.

In the United States, the reduction of real interest rates must continue to receive high priority attention. For its part, Japan must allow its interest rates to be set by market forces. The basic factors that underlie the interest rate distortion need to be addressed.

In addressing yen undervaluation, highest priority should be given to liberalization of Japanese financial and capital markets, and especially the encouragement of capital inflows. The much-touted reduction of Japanese capital flow barriers has been one-sided. Capital now flows out of Japan much more freely than it did in the past, as described by the previous testimony. But there has been no commensurate increase in capital inflows. This one-sided adjustment in capital flows is a major contributor, in our view, to the yen-dollar exchange rate imbalance.

Restraints on the flow of yen need to be removed. Ultimately, there should be complete internationalization of yen financial markets. In my written statement I have listed a number of possible Japanese actions directed toward this goal.

Concurrently, Japan needs to take steps to liberalize foreign direct investment. The government's screening and approval process remains a major obstacle to foreign direct investment.

The actions I have discussed are aimed at achieving an appropriate long-term equilibrium in the yen-dollar relationship. But there needs to be short-term action as well, and we propose the following:

One, declare that we have a problem. A simple joint declaration by the United States and Japan that the governments intend to undertake a joint program to bring the exchange rate to an appropriate level will, in our view, help strengthen the yen relative to the dollar, that simple declaration.

Second, undertake joint intervention in support of the yen. The United States could convert more of its reserves into yen and Japan could reduce permanently its large dollar reserves.

The CHAIRMAN. Could I interrupt you there? If such a declaration were made, how soon do you think there may be an impact? Could it be an immediate psychological impact?

Mr. MORGAN. I do not know, and I would appreciate the comment of my associates at this table, Mr. Chairman. But I would observe that when the yen hit 278 early in November of this year, and when Mr. Nakasone arrived in this country, which I believe was in February, a significant improvement had occurred.

I do not believe that is all serendipity. I do believe the impact might be felt within 90 days.

The third point is, for shock effect it may be necessary to impose a surcharge on Japanese goods. We believe this can be accomplished consistent with both countries' obligations under the GATT. But I do identify it as being strong medicine.

Fourth, we believe the United States should request that the IMF [International Monetary Fund] look at Japanese exchange rate relationships. The IMF Articles of Agreement call for review of a country's policies that by their exchange rate effects allow an unfair competitive advantage.

We view these four measures as temporary. Hopefully, implementation of the longer-range measures addressed earlier would obviate their need for an extended period.

Finally, I would like to address the question of whether the present international system that determines exchange rates is working properly. Many people believe it is not. There is broad concern that capital movements are overwhelming the traditional role of trade flows in determining exchange rates.

Technically, the present system should dictate exchange rates that reflect the trade competitiveness of the trading partners. But that technical purity is destroyed by the kinds of trade and capital flow barriers that the Japanese maintain. So it seems appropriate that the United States seek to determine what kinds of adjustments need to be undertaken to assure that the exchange rate system works equitably.

Mr. Chairman, in summary let me repeat three general themes:

One, the present system of exchange rates is not properly accounting for trade competitiveness. Its failures are influencing the protectionist sentiments that are growing in the world.

The second theme: The United States has a part to play in resolving this problem. U.S. domestic policy decisions must take greater cognizance of the implications for our position in the international marketplace.

And third, a heavy burden lies on the Japanese shoulders. They must, either by their own initiative or by force of ourside pressure, take major steps to open their capital markets and to internationalize their financial system.

Mr. Chairman, if I could have one more moment, I would like to comment briefly on Mr. Conahan's earlier statement. GAO has developed, as we see it, four preliminary conclusions, and while we may disagree with some of the supporting analysis, there is some commonality of themes between their statement this morning and our own.

For example, it is precisely GAO's points on the interaction of exchange rates with other international and domestic policies that underlies American business complaints about the yen-dollar relationship. In my statement, we have wanted to cite Japanese capital flows and the wide spread in United States and Japanese interest rates as the major culprits. But these conclusions beg the question:

If the system does not work now, what can be done to improve it? I believe the series of country, bilateral and possibly multilateral initiatives I referenced provide a meaningful way to begin looking at the what do we do about this question.

But, Mr. Chairman, as a general matter I believe the scope of the GAO study should be broadened. It focuses primarily on short-term cyclical currency movements and does not fully address the longer-term problems that have kept the yen persistently undervalued. It does not take adequate account of Japan's network of investment controls, import and export restrictions, interest rates set by fiat, and their accumulation of reserves, which on balance cause the yen to trade weaker, and which I thought your line of questioning with Mr. Conahan developed very nicely.

I believe the study needs to take a wider perspective to be useful. The fact that it remains in process may allow you to request such a broadened scope.

On the matter of manipulation, that is a word we have been trying to delete from our vocabulary, just like you have. Unfortunately, its connotations are very inflammatory and its meanings are so vague and so varied that it is unproductive to even address the question or to focus upon it.

What business has said is that the Japanese system that controls investment, capital and monetary flows, and to some degree interest rates, has a marked impact on exchange rates. It is these systemic aspects of Japan's international economic relations that have to be changed if the yen is to become a true international currency and ultimately reach an appropriate exchange rate vis-a-vis the dollar and the other currencies.

Mr. Chairman, I am very indebted to you for your attention and for your asking us to appear on behalf of the Business Roundtable.

[Mr. Morgan's prepared statement follows:]

PREPARED STATEMENT OF LEE L. MORGAN

Thank you, Mr. Chairman. It's a pleasure to be here this morning—on behalf of the Business Roundtable—to discuss a matter that I have often characterized as the single most important bilateral economic problem confronting the United States and Japan.

Of course, I'm referring to the sustained undervaluation of the Japanese yen and the implications of that undervaluation for the relative competitiveness of United States and Japanese goods in the world marketplace.

Mr. Chairman, I have a prepared statement that I believe addresses most of the questions you posed in your letter of invitation. In addition, I'd like to briefly comment on the remarks just made by Mr. Conahan, of the General Accounting Office.

As we look at the issue before us, I don't believe it's very constructive for us to debate whether the Japanese yen has stayed undervalued, relative to the dollar. I don't hear any credible economists saying there isn't an exchange rate problem. Unfortunately, that's where the consensus ends. There is not total agreement on the causes of the yen-dollar misalignment, or what to do about it.

Because of this vacuum, I, along with my colleagues in the Business Roundtable, undertook to develop a list of suggestions for action by the United States and Japan to address the yen-dollar imbalance. We've presented these proposals to our Administration, and offer them today to help further this Committee's debate on the topic.

In asking for action, I would remind policymakers in Washington and Tokyo that many Japanese businessmen are expressing as much concern about this problem as we are. I'd like to read an excerpt from a speech recently made by Isamu Yamashita, director and chairman of Mitsui Engineering and Shipbuilding Co. He said:

"Looking back at the past year, I think we can say that without question one of our most serious problems in Japan has been the misalignment of the dollar and the yen . . . the undervalued yen added fuel to the flames of international resentment against Japan, worsening our trade relations with the United States and increasing protectionist sentiments. I am deeply, deeply concerned about this problem.

"The reasons for this problem are complex, but the most obvious ones include high interest rates in the United States and the lack of investment opportunities in Japan . . . of course, all major currencies were affected by the same phenomenon, but the misalignment is more extreme in the case of the yen because the yen is not fully internationalized and more subject to speculative fluctuation."

Mr. Yamashita continues:

"This is one reason why we support continued steps to internationalize the yen. It is also important for the United States to take macro-economic policies that take into account the competitiveness of the U.S. economy in world markets. In a longer run sense, both our governments need to review the operation of the international monetary and financial systems and to try to explore imaginatively ways and means of designing a system beneficial to trade. The main point is that neither country can correct the present misalignment alone; both must take steps."

Mr. Yamashita stresses precisely the points that U.S. businessmen have been making. Now we'd like to see our government take some initatives to correct the problem. We should acknowledge here today that from its absolute weakest point last November of 278 to the dollar, the yen has strengthened to its present value of about 235 to the dollar. However, viewed over the perspective of the last 4 years, in real terms adjusted for differences in inflation, the yen is still 35 percent weaker than it was in 1978.

During the last 4 quarters for which full economic information is available, Japan's exports of goods and services in constant yen grew at a 4.9 percent rate, while those of the United States, France, United Kingdom, and Germany declined at rates of from 6 to 13 percent.

These facts argue rather conclusively, in my opinion, that the probelm cannot be brushed aside as the strength of the U.S. dollar; rather, the facts point to the weakness of the Japanese yen. Japanese export performance continues to be relatively strong at the expense of other industrial nations.

Clearly, this situation demands action. To say there is consensus in the business community on every detail of a proposed program would be an exaggeration. But some general themes and specific recommendations have clearly emerged and I would like to summarize them for you.

Many analysts agree that the appropriate yen/dollar exchange rate should today be no weaker than 200 yen to the dollar. This figure represents a basic structural equilibrium rate around which short-term cyclical variations could

occur. Variations have occurred in the yen-dollar rate in the past year, but they've been around a significantly higher base than 200/1.

The interest rate spread between the United States and Japan is a major factor affecting the relative valuation of the currencies. There is general agreement that while *Japanese savings propensities* are an important contributor to this differential, conscious insulation of the yen from worldwide interest rate trends exaggerates the spread.

Thus, we recommend policies in both countries to reduce that interest rate differential.

In the United States, the reduction of real interest rates must continue to receive high priority attention. This will require firm control over the growth of the U.S. budget and the deficit.

To complement our domestic efforts, the United States should insist that Japan allow its interest rates to be set by market forces. An induced, short-term raising of Japanese interest rates is not sufficient. The basic factors that underlie the interest rate distortion need to be addressed.

Highest priority should be given to liberalization of Japanese financial and capital markets and especially the encouragement of capital inflows. The much-touted reduction of Japanese capital flow barriers has been one-sided. Capital now flows out of Japan much more freely than it did in the past. But there has been no commensurate increase in capital inflows. This one-sided adjustment in capital flows is a major contributor to the yen-dollar exchange rate imbalance.

Restraints on the flow of yen need to be removed. Ultimately, there should be complete internationalization of yen financial markets. In my statement I've listed a number of possible Japanese actions directed toward this goal.

1. Elimination of the yen interest rate ceilings on loans and deposits in Japan.
2. Removal of restraints on the issuance of yen bonds and on short-term yen-denominated bank borrowing by foreign investors.
3. Increase in the limits on certificates of deposit denominated in yen.
4. Establishment of a treasury bill market in yen, open to foreign investors.
5. Allowing importers to finance in yen, rather than having to borrow dollars to pay for imports.
6. Allowing other governments to hold more of their reserves in yen.
7. Undertaking aggressive foreign borrowing, with the proceeds converted to yen.
8. Allowing purchase of yen in the forward exchange markets without restrictions.

Concurrently, Japan needs to take steps to liberalize foreign direct investment. The government's screening and approval process remains a major obstacle to foreign direct investment. Restrictions on stock purchases make it very difficult for a foreign entity to acquire a Japanese company.

Most of the actions I've discussed are aimed at achieving an appropriate long-term equilibrium in the yen-dollar relationship. But there needs to be short-term action as well, because in the view of many of us, the problem is critical to our short-term economic vitality. Thus, we propose the following:

1. Declare it a problem! The imbalance in the yen-dollar relationship is, in the view of Japanese and American businessmen, causing economic and political problems for both sides. A simple joint declaration, by the United States and Japan, that the governments intend to undertake a joint program to bring the exchange rate to an appropriate level will help strengthen the yen relative to the dollar.
2. Undertake joint intervention in support of the yen. The United States could convert more reserves into yen; Japan could reduce permanently its large dollar reserves.
3. For "shock effect," it may be necessary to impose a surcharge on Japanese goods. We believe this can be accomplished consistent with both countries' obligations under the GATT.
4. We believe the United States should immediately request that the IMF look at Japanese exchange rate relationships. The IMF Articles of Agreement call for a review of a country's policies that affect exchange rates where the exchange rates allow an unfair competitive advantage over other members. We believe the present situation demands such a review.

Let me repeat that we view these four measures as temporary and needed to provide immediate correction of a major problem. Hopefully, implementation

of the longer range measures discussed earlier would obviate the need for long-term intervention and surcharge programs.

Finally, I'd like to address the question of whether the present international system that determines exchange rates really works properly. Many people believe *it does not; that is, there is broad concern that capital movements are overwhelming* the traditional role of trade flows in determining exchange rates.

Technically, the present system should dictate exchange rates that reflect the trade competitiveness of the trading partners. But that technical purity is destroyed by the kinds of trade and capital flow barriers that the Japanese maintain. So, it seems appropriate that the United States seek to determine what kinds of modest or major adjustments need to be undertaken, to assure that the exchange rate system works equitably.

Mr. Chairman, in summary, let me repeat three general themes that run throughout this presentation:

1. The present system of exchange rates is not properly accounting for trade competitiveness. Its failures are influencing the protectionist sentiments that are growing in the world. This may require some strengthening of our international institutions—like the GATT and IMF—to deal with exchange rates more effectively. But unless all nations play the trade and investment game fairly and equitably, there is no exchange rate system that will provide satisfactory results.

2. The United States has a part to play in resolving this problem. U.S. domestic policy decisions must take greater cognizance of the implications for our position in the international marketplace.

3. A heavy burden lies on the Japanese' shoulders. They must, either by their own initiative or by force of outside pressure, take major steps to open their capital markets and internationalize their financial system. The U.S. business community is fully prepared to undertake initiatives as needed to assert such pressure.

Mr. Chairman, I'll thank you and the Committee in advance for your attention to the set of recommendations I've just laid out. We believe the United States and Japanese Governments should be able to build on the framework we've set out here. We urge both governments to do so.

I'm prepared to address any questions you may have.

The CHAIRMAN. Mr. Morgan, you have given us a full platter here to work on. I can assure you that many of the suggestions that you have made, particularly with respect to the international organizations such as IMF—we will certainly be in contact with them. Your views will be passed on to GAO, and the study fortunately is not completed. It is not a final study and I think it can be broadened.

We thank you very much.

Mr. Fred Bergsten, we are delighted to see you again and happy to have you here.

Senator HELMS. Mr. Chairman, I must go back to the Agriculture Committee. Could I have one moment?

The CHAIRMAN. Yes; of course.

Senator HELMS. We have a big problem here. We are all scheduled to be three places at one time, which is kind of difficult even in this zoo where we work.

Mr. Morgan, I was just telling Senator Percy that rarely do we hear such perceptive comments as you have given. Now, I happen to be very friendly with the Japanese. I like them. I am old enough to remember World War II, but I have kind of forgotten that.

But you are exactly right in so many points that you made. For example, the protectionist attitude that is growing in this world, and you had better believe it is growing in this Congress.

The Agriculture Committee reported out an agriculture export bill a couple of weeks ago, Mr. Chairman. Perhaps you are familiar with the provisions of that.

I do not like the prospect of a trade war, but I like even less the reality that the war is going on and we just have not been in it.

Also let me say that I visited Mr. Nakasone some years ago, and he struck me as a highly intelligent man. He does have, of course, his political pushes and pulls in his country, as we do. But I think that Mr. Nakasone understands that this will not go on forever from his standpoint or ours.

Now, there was a Presidential candidate who had a good line and it got a round of applause everywhere he went, about the Toyotas on the docks. And that was just a prelude to the feeling that is spreading across this country today, and it certainly is being felt in this Congress. I do not want it to get out of hand, and the other countries of the world had better make sure that Pandora's Box is not all the way opened.

I went over to Geneva at the President's request in November and tried to participate in GATT. That is sort of like trying to beat a rattlesnake to death with a wet noodle. They laugh at you. Not only Japan, but the European Community. They are just going through the stratosphere, of shooting themselves in the foot with their subsidies and all the other predatory practices, as I view them as an American. They are going over the cliff.

The message that I think you are trying to say is, let us not all go over the cliff together. Let us stop this foolishness.

I notice your point 3 in your prepared statement, you say, "For shock effect it may be necessary to impose a surcharge on Japanese goods." Well, they are old masters at the surcharge. They have just imposed some on something very dear to my heart from North Carolina, that is to say cigarettes. They lowered it on the one side and raised it on the other.

But somewhere along the line the commonsense of your statement, sir, needs to be examined by this Government of ours. Now, I have taken a long time to express my admiration of your forthrightness. But if we do not do something and do it relatively quick, we are going to be in a real problem.

Finally, Mr. Chairman, I think there is a pretty good argument in Mr. Morgan's statement that we ought to take a look at the gold standard again. That would tend to level things off a little bit, you know, if we had a base for our money that we do not now have.

In any case, Mr. Morgan, I enjoyed your testimony.

Thank you, Mr. Chairman, for yielding to me.

The CHAIRMAN. We thank you very much, Senator Helms, for stopping by and for your comments. I concur with you that the protectionist movement in the Congress and in the country, particularly among organized labor, is a fact of life that Japan has to fully understand. And it would be a disaster, I think, for world trade in the long run if we succumb to it, and we have to take measures that will ward that off, and I think both countries recognize that.

Mr. Bergsten.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Mr. BERGSTEN. Thank you very much, Mr. Chairman. It is a pleasure to be here before you and the committee again. I have provided in my written statement an extensive analysis of the problem and its impact

on the U.S. economy and foreign policy. I submit that for the record and with your permission will summarize it briefly.

The CHAIRMAN. Thank you very much, and the full copy will be incorporated in the record.

Mr. BERGSTEN. I want to say at the outset that I largely agree with the statement made by Mr. Morgan on behalf of the Business Roundtable. I think it is a rather noteworthy, almost dramatic development that the U.S. business community, really for the first time, has begun to focus on the exchange rate problem as a central issue of U.S. economic and trade policy.

That is enormously important in terms of expanding recognition of the issue and the urgency of doing something about it, and I want to take the opportunity to commend Mr. Morgan himself and the Business Roundtable, with his leadership, for having taken initiatives in this area to the extent that they have.

For my own part, I would echo the basic conclusion that the continuing substantial misalignment of the dollar exchange rate, particularly vis-a-vis the Japanese yen, remains the most critical trade and international economic problem currently facing the United States. During the last 2 years, 1981–82, the decline in U.S. net exports which stems from dollar overvaluation accounted for over two-thirds of the total decline in U.S. GNP.

The deterioration of our trade balance was far greater than the slump in the housing industry or the slump in the auto industry, and was clearly the single most important cause of the recession in this country during the past 2 years.

In 1983, almost wholly because of dollar overvaluation, the global U.S. current account deficit will soar to at least $40 billion, about three times the previous record. That would comprise a merchandise trade deficit of $75 billion or more, offset in part by our structural surplus on services, but still leaving a current account deficit on the order of $40 billion or more—the previous high having been $14 billion back in 1977 and 1978.

As a result of this deterioration in our external accounts, economic recovery in this country will be retarded significantly and at least 1 million additional job opportunities will be lost. You focused quite properly on the question of jobs. Already we have lost at least a million jobs because of the deterioration in our trade balance over the last 2 years, coming from a decline in export sales and further import penetration as a result of the currency misalignment. We are going to lose at least another million job opportunities over the next year. All this obviously makes our already critical unemployment problem worse.

In addition, pressures for trade restrictions will intensify still further and, as you and Senator Helms were both suggesting, may become unmanageable. My own study of the postwar history of U.S. trade policy suggests to me that dollar overvaluation, even more than the unemployment rate, is the most accurate leading indicator of the onset of severe protectionist pressures. We are certainly seeing that now.

In this picture of large and growing overall U.S. deficits, our bilateral deficit with Japan will account for over half of the total current account deficit, highlighting the importance of the yen aspect of the problem and the Japanese angle to it.

Despite the depth of the problem, neither the United States nor the Japanese authorities are doing anything about it. Though it is clearly the major economic issue between our two countries, and perhaps the most important overall issue between our two countries, the dollar-yen misalignment apparently was totally ignored during the visit of Prime Minister Nakasone to this country in January.

If anything, current policy is making the situation worse. Continuing failure here, including here in the Congress, to decisively reduce the outyear deficits in our Government budget maintains upward pressure on U.S. interest rates and thus continuing upward pressure on the dollar, tending to push the exchange rate still further from where it should be.

In Japan, the stress on reducing budget deficits, despite their rather modest size when seen in the light of Japan's high savings rate and the present cyclical situation, but implies an early lowering of Japanese interest rates to promote recovery there, which would produce further downward pressure on the yen exchange rate.

There has been a great deal of pressure in Japan already to lower interest rates further. The Governor of the Central Bank of Japan has so far opposed doing that, but clearly it is in the works in the next month or so and would make the situation worse.

Third, continued U.S. rejection of direct intervention in the foreign exchange markets permits, at a minimum, intensification of the misalignment as has occurred since mid-January and it clearly misses opportunities to improve the situation.

Mr. Chairman, you asked Mr. Morgan a moment ago how fast could a declaration of policy concern rectify the situation? My answer would be that it depends very much on the environment within which the statement were made. But let me give you an example of where I think it could have had dramatic impact.

From early November to early January, just before Prime Minister Nakasone visited the United States, the yen strengthened by 20 percent, moving about halfway of what was needed. It was going in the direction that Mr. Morgan and I and everybody are calling for. Suppose that President Reagan and Prime Minister Nakasone, when they had come out onto the north portico after their meeting, would have said something like the following: We welcome the strengthening of the yen in the exchange markets as a major contribution to better United States-Japanese relations. We think it has gone only part way, however, and believe that further progress in that direction will strengthen the world economy, world trade, and the relations between our countries.

And then, perhaps on background, Treasury officials might have indicated a willingness to intervene in the markets to promote that process. I think the yen might be at 200 to 1 to the dollar today, instead of close to 240:1 instead. The kind of statement Mr. Morgan called for, backed up by appropriate intervention in the market, if done in a context to ride with market forces, as was then occurring because the yen was strengthening, might have had a dramatic impact. We might have been down the road to solving the problem, at least in the short run.

The CHAIRMAN. In other words, the drama of an announcement is important, provided it is backed up with the conviction that there is

going to be followthrough. The immediate effect would be felt in anticipation that there would be the followthrough.

Mr. BERGSTEN. Exactly. It should be done in a context to move with market forces and with the indication of backup. Obviously it would be even better if the underlying policy changes of the type I referred to were made, but even without that I think we could have had a further dramatic improvement in the situation.

Finally, just ticking off the ways in which current policy is ignoring the situation and in fact making it worse, and going back to Japan, they have continued to ignore the possibility of rectifying the situation by borrowing heavily abroad and/or through administrative guidance limiting the outflow of private capital, as they have done many times in the past, as recently as 1979 and 1980.

My conclusions as to what needs to be done are as follows:

First, and this agrees with Mr. Morgan, there is an urgent need for the United States and Japan to declare publicly their intention to solve the problem and to work out a joint program to bring the yen-dollar rate to 200 to 1 or less as quickly as possible from the current level of about 237 to 1, through some combination of steps that I will mention.

It should be noted that it is conceivable that the needed exchange rate correction might take place on its own. A continuing decline in world oil prices, for example, could strengthen the yen and other currencies against the dollar, just as the two upward oil shocks in the 1970's weakened those currencies because of their greater dependence on oil imports.

A severe deterioration in the U.S. trade and current account positions, as I mentioned, will become increasingly evident to the market over the next few months, and again could help rectify the situation. If interest rates declined here, as is certainly possible, that too would tend to bring the yen up. Finally, renewed concerns about a revival of inflationary pressures in the United States, stemming from the huge budget deficits and the allegations of excessive expansion of money supply by the Federal Reserve, could weaken the dollar.

However, I think one should not rely on market forces at the moment to change the situation. There have been several false starts during the past year when the yen and other currencies started to strengthen, only to fall back to and even beyond their previous lows. The latest yen-strengthening stalled at just under 230 to 1, leaving the yen considerably undervalued and remedying only about one-half the competitive imbalance, and it subsequently has weakened again a bit more.

I think it is critical to remember that we are in a race against time. Protectionist trade pressures, as you have already stressed, could overwhelm our political process this year or in Presidential election year 1984 absent clear, full and sustainable correction of the currency misalignment which promises within a finite period to restore at least a modicum of equilibrium in economic relationships between the two countries.

My own suggestions, Mr. Chairman, therefore run along the following lines:

First, and critically important, further substantial reductions in U.S. interest rates. With the decline in recorded U.S. inflation to very

low levels, indeed close to zero in the last few months, it seems incomprehensible that nominal interest rates remain at 8 percent or more at the short end of the spectrum and 10 or 11 percent in the long-term markets. These are historically record levels of real interest rates.

Short-term rates need to decline by at least another 200 basis points. In addition to the essential role such a change would play in encouraging recovery of the domestic economy, it would do far more than any other policy action to promote the needed correction in the dollar exchange rate.

The key policy step to this end is of course decisive action to reduce the huge out-year budget deficits which our Federal Government now contemplates, perhaps along the lines suggested in the recent bipartisan budget appeal launched by five former Secretaries of the Treasury and your good friend and mine, Peter G. Peterson.

Second, the Government of Japan and its government entities should aggressively borrow in the foreign exchange markets, converting the proceeds immediately into yen, to strengthen their currency. This would kill two birds with one stone for the Japanese. It would help them finance their huge government deficits without cramming more of their treasury paper into the commercial banks, and it would give them a basis for supporting the yen exchange rate.

They did this only 2 or 3 years ago to finance the huge current account deficits they were then running. They could do it easily. They should be urged to do it by our own Government.

Third, if necessary, the Japanese Government could through a few phone calls to insurance companies, banks, and other big institutional investors in Japan, limit the outflow of capital on a temporary basis through their famous administrative guidance system. Again, as recently as 1979 they did that very actively. Capital outflow dropped to zero in some quarters. It could be done again.

I share the view that over time one wants to achieve maximum liberalization of the Japanese capital market, but I do think that is a long-term process and, whereas I support all of Mr. Morgan's proposals to that end, I think at best they will take time to implement and have impact. I in turn think it is so urgent to get the yen-dollar rate correct that I would back away for a moment and support temporary limitations on outflow of capital from Japan if necessary to achieve the exchange rate target, all the time working on the longer run steps.

Finally, I think we simply have to resume joint intervention in the exchange markets by the United States and Japanese monetary authorities, once the trend clearly was turned, to accelerate the pace and extent of the currency movement. The authorities could then let it be known that their intervention was based on a common view that substantial changes were needed in the existing rates and that they were determined to see that such changes occurred.

Mr. Chairman, you referred back to the dollar support program of only 4½ years ago. I have all too intimate a recollection of that, having been Assistant Secretary of the Treasury for International Affairs at that time. Your point was very well taken. There was international agreement that the dollar was too weak. The U.S. Government took dramatic steps—a $30-billion package, a 1 percentage point rise in the discount rate—to do something about it. There was full international

cooperation in support of that move from the Germans, Swiss and Japanese Governments, as you mentioned.

All one is suggesting now is a parallel operation when the shoe is on the other foot. Now it is the yen and some other currencies that are too weak. What one needs is the same kind of package, a recognition that there is a problem, decisive action by the country whose currency is too weak, with full support by the others who are intimately involved, including most notably the United States.

It is not a dramatic thing to do. It has been done on many occasions before. The absence of doing it is what is noteworthy.

In addition to its immediate effect, incidentally, such action could represent an important milestone toward constructing a more effective exchange rate system, a target zone system as I would call it, which is needed over time to avoid further replication of the three major episodes of dollar-yen misalignment during the past 15 years.

Finally, Mr. Chairman, two things we should not do:

First, the Japanese should not reduce their interest rates further. As I mentioned before, there is a lot of pressure within Japan to do that. But if they were to do it, absent a greater reduction in interest rates here, the yen would weaken more and that would make the situation worse.

I am fully sympathetic to the problem the Japanese have in trying to expand their economy through fiscal policy, given the large nominal level of their budget deficits. But it is the only course available to them without making this international problem worse.

Second, and here I would disagree with Mr. Morgan, I think it would be a mistake to erect new trade barriers in this country in response to the monetary problem that we are discussing. An import surcharge of the type he suggested or a Japanese export surcharge, which has also been mentioned, would be a policy mistake because, given the level of economic difficulties around the world and the degree of major tension among the industrial countries, such action, by the United States especially, could trigger extensive trade conflict and go far toward destroying the GATT system.

However, I would point out that an import surcharge would also be a mistake for purely technical reasons, because new import controls, far from resolving the problem, would probably intensify it. Import controls, after all, would have the objective of improving the U.S. trade balance, and that prospect of improving the trade balance would tend to strengthen the dollar further in the exchange markets. So one could actually get an offsetting impact in the exchange market to the trade barrier that was set in place to try to improve the situation.

That offsetting move in the exchange market could counteract any gains from the controls themselves. In fact, it would penalize American industries and workers across the board because of the greater competitive difficulty of an even stronger dollar. So it is my judgment that new trade restrictions do not have a place in resolving the problem.

In conclusion, it should be clear that the kind of proposals that I am talking about, and that Mr. Morgan talked about too, would require some important policy changes, including on the part of our own administration here. In my view the administration simply has to face the basic inconsistency between its continued, quite proper and lauda-

ble devotion to free trade with its devotion to laissez faire in the currency sphere, which undermines the possibility for maintaining free trade.

The reason, of course, is that exchange rates affect trade dramatically, but the exchange rates in themselves are determined by factors, as Mr. Morgan said, going way beyond trade. So by maintaining a completely hands-off approach to the currency problem, the administration and others who take that view undermine their own possibility to maintain an open trading system and fight off both the protectionist pressures and the adverse effects on our own economy which we are now seeing in such severe magnitude.

Thank you very much.

[Mr. Bergsten's prepared statement follows:]

PREPARED STATEMENT OF C. FRED BERGSTEN

SUMMARY AND RECOMMENDATIONS

The continuing substantial misalignment of the dollar exchange rate, particularly vis-a-vis the yen, remains the most critical trade and international economic problem currently facing the United States. In 1981–82, the decline in U.S. net exports which stemmed from dollar overvaluation accounted for over two-thirds of the decline in total U.S. GNP. The deterioration of the trade balance was far greater than the decline in the housing or automobile industries, and was the single most important cause of the recession. In 1983, almost wholly because of dollar overvaluation, the global U.S. current account deficit will soar to at least $40 billion—about three times the previous record. As a result, economic recovery will be retarded significantly and at least 1 million additional job opportunities will be lost. Pressures for trade restrictions will intensify still further, and may become unmanageable. Our bilateral deficit with Japan will account for well over half the total current account deficit.

However, neither the United States nor Japanese authorities are doing anything to deal with the problem.[1] Though clearly the major economic (and perhaps overall) issue between the two countries, the dollar/yen misalignment apparently was ignored during the visit of Prime Minister Nakasone to Washington in January. If anything, current policy is making the situation worse:

Continuing failure here to decisively reduce the outyear budget deficits maintains upward pressure on U.S. interest rates, and thus continuing upward pressure on the dollar.

Japan's stress on reducing its budget deficits, despite their rather modest size when seen in the light of Japan's high savings rate and the present cyclical situation, implies early lowering of Japanese interest rates to promote recovery there and hence further downward pressure on the yen.

Continued U.S. rejection of intervention in the foreign exchange markets permits intensification of the misalignment, as has occurred since mid-January, and misses opportunities to improve the situation (e.g., supporting the sharp rise of the yen which occurred from early November 1982 until early January of this year).

Japan continues to ignore the possibility of rectifying the situation of borrowing heavily abroad and/or, through administrative guidance, limiting sharply the outflow of private capital (as it has done many times in the past, as recently as 1979–80).

There is an urgent need for the United States and Japan to declare publicly their intention to solve the problem and work out a joint program to bring the yen-dollar rate to 200:1 or less as quickly as possible, from the current level of about 240:1, through some combinations of the steps mentioned here. They should also, with the major European countries, launch immediately a serious effort to improve the functioning of the system of flexible exchange rates to help avoid the reappearance of such major misalignments, which in the yen-dollar case have now occurred three times in the last 15 years. In the absence of such

[1] Secretary of the Treasury Regan was quoted as follows in the New York Times, March 29, 1983, p. D2: "We would like to see a somewhat weaker dollar in order to help our exports. But that doesn't mean we're going to do anything about it."

conscious efforts, the U.S. economy will suffer continuing severe losses at least through 1984; it may prove impossible for the United States to preserve an open trading policy; and United States-Japan tensions will escalate to levels not seen heretofore in the postwar period.

THE DOLLAR PROBLEM

The substantial overvaluation of the dollar in the exchange markets, in terms of the underlying competitive relationship between the United States and the other major trading countries, is by far the most critical trade problem—and one of the most critical overall economic problems—the United States faces. From its lows of late 1978 to its recent highs, reached initially in mid-1981 and again in the autumn of 1982, the dollar rose in value by about 30 percent against a trade-weighted average of the other major currencies. During that period, U.S. inflation on average ran about the same as inflation in these other countries. Hence there has been an enormous deterioration in the international price competitiveness of the United States in world trade. Even allowing for some dollar undervaluation in late 1978 and the imprecision of all analyses in this area, and for the modest correction late last year, the dollar is clearly overvalued—in terms of trade competitiveness—by about 20–25 percent.

The adverse impact of this situation on the U.S. economy is already clear:

From the first quarter of 1981 through the fourth quarter of 1982, U.S. net exports of goods and services in real terms declined steadily by a total of $21 billion (seasonally adjusted annual rate in 1972 dollars, as incorporated in the GNP accounts). As noted, this was the biggest single source of the economic downturn of 1981–82.

The merchandise trade deficit reached an all-time record high in the second half 1982 of almost $50 billion and the current account deficit exceeded $22 billion (seasonally adjusted annual rate in current dollars, imports and exports both valued f.a.s., as in the balance of payments statistics).

This dramatic deterioration occurred despite the recession and a substantial decline in both the volume and price of oil imports. During all previous postwar recessions, the U.S. trade balance has improved—sometimes strongly, as in 1975 ($15 billion)—because demand for imports has fallen along with demand for anything else. Moreover, the value of oil imports declined sharply from 1981 to 1982. Hence one would have expected a notable improvement in the U.S. trade balance in 1982 instead of the enormous deterioration which occurred, due almost wholly to the overvaluation of the dollar.

Unfortunately, we have only begun to see the adverse effects on the economy of the dollar overvaluation. A variety of studies show that the U.S. trade balance tends to deteriorate by about $3 billion for every percentage point loss of U.S. price competitiveness, with a lag of 1 to 2 years. We should thus expect an ultimate rise of about $60 billion in the trade deficit, even with the overvaluation estimated conservatively at 20 percent.[2]

Since the trade deficit was already running at about $25 billion in 1980, before the overvaluation began to occur, we should not be surprised to see it approach $80–$100 billion sometime in 1983 or early 1984, and continue near this level for some time in light of the continuation of the overvaluation well into this year. For the full year 1983, the trade deficit will almost certainly hit $75 billion as initially forecast by the administration on the basis of its initial (and more modest) forecast for economic recovery, despite the benefit of further declines in the price of oil imports.

In short, it is clear that the U.S. trade deficit will soar to record levels in 1983, (The annual high, prior to 1982's $36 billion, was $34 billion in 1978; as noted, the previous quarterly high annual rate of $45 billion in the first quarter of 1978 was already exceeded in the second half of last year). The current account deficit will rise to at least $40 billion, almost three times the previous record (1977–78).

THE IMPACT ON THE U.S. ECONOMY

This deterioration in the U.S. external position will take between 1–1½ percentage points off our GNP, sharply reducing the rate of recovery. Between 1 and 2 million additional job opportunities will be lost, in addition to the sizable

[2] It should be noted that changes in the terms of trade can alter this outcome as recorded in current dollars. A sharp improvement in the U.S. terms of trade in 1981–82, for example, masked the extent of the deterioration for a while and explains why real net exports declined more than the current account in nominal dollars.

number lost already, intensifying still further the unemployment problem. In short, the impact of the dollar overvaluation on U.S. trade is one of the foremost economic problems facing the United States in 1983 and beyond.[3]

These developments are particularly tragic because the international competitiveness of the U.S. economy had been dramatically reasserted in the late 1970's. From 1978 through 1980, U.S. exports rose twice as fast as world trade. Our share of world exports of manufactured goods regained the level of 1970, reversing all of the competitive losses of the earlier part of the decade. Our current account improved by $20 billion despite a rise of $35 billion in the cost of oil imports—a gain of $55 billion on everything else. It became clear once more that the United States, taken as a whole, could compete quite effectively in the world economy. But the overvaluation of the dollar has undermined our position once more, and must be rectified immediately.

Moreover, throughout the postwar period, dollar overvaluation has been a key "leading indicator" of an outbreak of protectionist trade pressures in the United States:[4]

In the late 1960's and early 1970's, import controls were imposed for the first time on steel and extended substantially on textiles and apparel; the House actually passed the highly restrictive "Mills bill"; and Congress seriously contemplated the Burke-Hartke proposals, which would have blocked most U.S. imports of goods and most exports of capital and technology. Yet unemployment was relatively low during much of this period.

In the mid-1970's, barriers were raised on shoes and color television sets; restored for steel; and intensified once again for textiles and apparel. All this occurred while the United States was in fact recovering from the recession of 1975.

During the past 2 years, barriers have been imposed or extended in four major industries (autos, steel, sugar, textiles/apparel) despite the clear adherence of the administration to market approaches, including free trade. This time, of course, the impact of dollar overvaluation is intensified by the record postwar level of unemployment.

In a situation of severe dollar overvaluation, those seeking import relief (or export subsidies) have a powerful case. Even Adam Smith and David Ricardo, along with all contemporary analysts, base the case for a liberal trading policy on several key assumptions—including balance-of-payments equilibrium, which today takes the form of currency equilibrium.[5] The AFL–CIO and industries seeking government help in such an environment are in effect asking for policy intervention to correct the distortions generated by other policy intervention, such as loose fiscal policy and very high interest rates—in terms of the theory of economic policy, a "second-best" but defensible approach. I believe that their desire to remedy the situation by erecting new trade barriers is misplaced and would be a mistake, but it is clear that they are experiencing a real problem of substantial dimension and deserve a good deal of sympathy.

THE YEN DIMENSION

The overvaluation of the dollar is most critical vis-a-vis the Japanese yen for both quantitative and qualitative reasons.

Quantitatively, the dollar-yen misalignment is more severe than the misalignment between the dollar and any other major currency. From late 1978 until August 1981 (and, again, early November 1982), the dollar rose by over 50 percent in value against the yen. During that period, U.S. inflation exceeded Japanese inflation (on most indices) by over 20 percentage points. Thus U.S. international price competitiveness deteriorated against Japan by over 70 percent in 4 years. Is it any wonder that the United States-Japan trade imbalance has soared to record levels and that a major crisis exists in economic relations between the two countries?

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[3] The rise in the value of the dollar has aso reduced the observed rate of U.S. inflation, perhaps by 3–4 percentage points, from where it would otherwise be. However, the inevitable decline in the dollar (see below) will not only eliminate that source of improvement in the inflation numbers but propel them upward by a like amount. When determining an "underlying" or "core" inflation rate as a guide to policy, it is thus essential to adjust the published numbers for any temporary effect of exchange rate misalignments or corrections.

[4] See C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy," in William R. Cline, ed. "Trade Policy in the 1980's," Washington: Institute for International Economics, forthcoming July 1983.

[5] See C. Fred Bergsten and William R. Cline, "Trade Policy in the 1980's," Washington: Institute for International Economics, November 1982.

It should be recognized that there is some controversy as to whether the yen is in fact more undervalued than other important currencies against the dollar. At one extreme, Morgan Guaranty's "World Financial Markets" views the yen as the only one of the five major currencies which is significantly undervalued today.[6] On the other extreme, the recent Annual Report of the Council of Economic Advisors, while clearly recognizing that the dollar is substantially overvalued and causes "severe problems" for the U.S. economy, argues that it is overvalued about equally vis-a-vis all major currencies—leading to its conclusions that "there is no special yen issue" and that "the main causes of the U.S. trade deficit are to be found not in Paris or Tokyo, but in Washington."[7] (Most Japanese support this viewpoint, agreeing that the yen is undervalued but arguing that the DM and some other European currencies are equally undervalued.) My own view lies between these two: that the dollar is overvalued against a number of important currencies, but is more overvalued against the yen than against the others.[8]

In any event, it is clear that the qualitative impact of the dollar-yen imbalance is much greater than the impact of the dollar-DM or other imbalances because of the intensity of U.S. trade competition with Japan—both within the United States and Japanese markets, and in third markets around the world. This competition is far greater than between the United States and Germany, or any other country whose currency is also severely undervalued. A primary manifestation of this United States-Japan trade intensity is of course the spate of protectionist trade proposals aimed at Japan, notably including the "local content" bill for the automobile industry[9] and the "reciprocity" proposals.[10]

This is in fact the third time in the past fifteen years that currency misalignments have brought extreme tension to United States-Japan economic relations. To be sure, there have been ongoing problems in that relationship which relate to structural factors going well beyond the exchange rate, and some relatively new problems demand urgent attention in the context of "trade policy" more narrowly defined.[11] But:

In the late 1960's and early 1970's, the initial outbreak of such tension was primarily caused by the exchange-rate disequilibrium that eventually produced the breakdown of the Bretton Woods system of fixed exchange rates, including the dollar devaluations and yen revaluations of 1971 and 1973.

In the mid-1970's, a second round of conflict developed largely due to a modest overvaluation of the dollar (triggered by the huge recession-induced U.S. current account surplus of 1975) and Japan's intervention to keep the yen from appreciating despite very large Japanese current account surpluses.

Both of these past episodes were largely resolved when the exchange rates were corrected.[12]

Hence it is particularly critical once again to correct the yen-dollar misalignment, and to do so as promptly as possible. Expert judgments differ as to whether this requires the yen to rise in value to the level of 180 to the dollar, a point it reached briefly in 1978, or merely to 210–220:1. All observers, however, including

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[6] Morgan Guaranty, World Financial Markets, March 1983, p. 14. On its analysis, however, the Canadian dollar and Italian lira are also substantially undervalued.

[7] Economic Report of the President. February 1983. esp. pp. 61–67.

[8] The technical reason for these different viewpoints is their choice of a differing base period against which to compare the present situation. All are based on a purchasing power parity concept, which compares real effective exchange rates at the present time against a previous period which, in their judgment, best represents a situation of rough equilibrium. Morgan Guaranty uses March 1973, when widespread currency floating began; the CEA uses the 1973–80 average, to get a broader base; and my comparison runs from the dollar low of late 1978, which admittedly overestimates the amount of change—for which I correct my conclusion—but should not distort the relative change among the different currencies.

[9] It is instructive to note how U.S. policy of the past two years has greatly strengthened the Japanese automobile industry. The "voluntary" quota foisted on Japan by the United States has voided any incentive for the Japanese auto firms to cut their prices to obtain a higher share of the U.S. market; to the contrary, they have taken advantage of the fixed ceilings on the volume of their sales to raise prices substantially and sell higher priced cars. At the same time, the exchange-rate misalignment has enabled the Japanese firms to make enormous yen profits when converting their dollar earnings. As a result of the interaction of these two phenomena, the profits of these firms have risen sharply and positioned them to be even more formidable competitors in the future.

[10] For an analysis see William R. Cline, "Reciprocity:" A New Approach to World Trade Policy? Washington: Institute for International Economics, September 1982.

[11] As outlined in "The Japan Problem: What Is It, and What Should the United States Do About It?", testimony before the Trade Subcommittee of the House Ways and Means Committee on March 10 in which I reported on the results of a conference held at the Institute for International Economics on this topic on February 16.

[12] Details can be found in C. Fred Bergsten, "What To Do About the U.S.-Japan Economic Conflict," Foreign Affairs, Summer 1982.

most Japanese, agree that a substantial adjustment is needed—and needed quickly. It should be noted that the yen rose by about 20 percent from early November 1982 to early January 1983, before falling back again;[13] a rapid further rise of that magnitude, which is all that is needed, would seem to be quite feasible.

JAPANESE MANIPULATION?

Before turning to proposed solutions, it is necessary to assess the frequent charge that "Japan is manipulating the yen" to hold its value below market levels—presumably to enhance the competitiveness of Japanese trade. As noted, Japan in fact did carry out such intervention in 1976, when I happened to be the first person to draw attention to their actions.[14]

Right now there is no evidence that Japan has been directly manipulating a weaker yen. Indeed, the Bank of Japan has intervened substantially in the foreign exchange markets to keep the yen from weakening further; its published reserves declined by over $5 billion in 1982 as a result of that effort. Moreover, recent surveys of Japanese industry reveal that they themselves dislike the weak yen because it has sharply increased the cost of their oil and other imports—and that the stagnation of the world economy has negated much of the benefit from their enhanced competitiveness.[15]

Indirectly, however, two Japanese policies have contributed significantly to creating such a high degree of yen undervaluation. First, Japanese interest rates have been quite low by international standards. Coupled with the very high interest rates which have prevailed in the United States over the past 2 years, partly due to loose fiscal policy here and the resultant reliance on monetary policy to fight inflation, the result has been a sizable incentive to shift funds from yen into dollars.

At the same time, it must be recognized that real interest rates have been quite high by historical standards in Japan as well as in the United States. (The explanation for the coexistence of Japanese interest rates that are low internationally but high by Japanese standards is of course the relatively low level of inflation in Japan which, until quite recently, has been far below the comparable figure in the United States.) Moreover, the yen failed to strengthen for several month after U.S. interest rates began their sharp decline last summer. Some of that failure can be explained by the continued high level of real interest rates in the United States and, as noted, the yen did strengthen substantially in late 1982. But factors beyond changes in interest-rate differentials are clearly at work.

Many market observers believe that a major element in the picture is the general uncertainty now surrounding world economic and political events, which traditionally reinforce the "safe haven" role of the dollar. Others point to an apparent malaise within Japan itself, as its own dynamic economic growth has waned and its political system undergone a painful transition. Still others refer to the steady growth around the world of barriers to Japanese exports, which threaten Japan's future trade balances and thus the ultimate underpinning of its currency.

All of these factors have undoubtedly contributed to the undervaluation of the yen. However, I believe that the very powerful effects of a second Japanese policy—the extensive liberalization of its capital markets in late 1980—may be even more important.

For three decades after 1950, income levels in Japan rose enormously. A very high percentage of those incomes was saved. But high-saving, high-income

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[13] It might also be noted that this rise commenced at about the time that Nakasone was designated Prime Minister of Japan and decided to make an early trip to Washington, inter alia to try to resolve the trade friction between the countries, and that the U.S. business community began to voice strong concern about the yen exchange rate as a major source of those frictions. The rise in the yen then ceased at just about the time of the Prime Minister's actual visit to Washington, during which the Administration reportedly failed even to mention the exchange-rate issue to him.

[14] See my testimony before the House Banking Committee on June 3, 1976 and before the Joint Economic Committee on October 18, 1976 as well as "Let's Avoid a Trade War," Foreign Policy, Summer 1976. All three are reprinted in Managing International Economic Interdependence: Selected Papers of C. Fred Bergsten, 1975–1976, Lexington, Mass.: D.C. Heath and Co., 1977. It should be noted that a forthcoming book on Japanese international monetary policy by a respected Japanese economist, Ryutaro Komiya of the University of Tokyo, argues that the Japanese intervention of that period was justified by the need to rebuild foreign exchange reserves depleted in 1975 and did not have much impact on the exchange rate anyway.

[15] However, it should be noted that Japanese exports (and imports) have continued to rise in yen terms. The frequent reports of falling Japanese exports refer to their dollar value, which declined only because the yen weakened against the dollar.

Japanese had very little access to foreign investment because of their government's tight controls on capital outflow. Hence there must have developed in Japan an enormous pent-up demand for foreign investment.

When the liberalization of capital outflows was largely completed in December 1980, a classic portfolio adjustment took place. Japanese individuals and institutional investors, such as insurance companies, for the first time had widespread access to trillions of dollars worth of dollar and other foreign securities. No one can judge how large this adjustment will ultimately prove to be, nor how long it will take to complete. But the wholly predictable outcome was an enormous export of capital from Japan.

On the other side of the balance sheet, liberalization also produced sizable capital inflows—but of a much smaller magnitude. The previous incubation of the Japanese capital market, and its remaining shortcomings, meant that the array of yen assets which had become available to foreign investors was relatively limited. Hence the net result was a substantial outflow of capital from Japan and steady and sizable downward pressure on the yen.

This structural change in Japan's policy toward its capital account must have been a major factor in the subsequent weakness of the yen. The change was urged on Japan by the United States and other countries, and is surely the correct long-term policy. Japan is the second largest market economy in the world; its currency and capital markets can and should be major participants in international financial activities just as it participates so actively in trade and other economic endeavors. It can even be argued that, over time, internationalization of the Japanese capital market would make it far more difficult for Japan to maintain interest rates well below international levels—and hence preserve an undervalued yen.

In the short run, however, the pace of net capital outflow from Japan has simply overwhelmed its current surpluses and pushed the yen to levels which are far too low to sustain in terms of trade relationships between Japan and other countries (including, but by no means limited to, the United States). Hence any effort to restore proper strength to the yen may have to interrupt, at least temporarily, the liberalization of the Japanese capital market. In one sense, this would represent no more than a return to the immediate pre-liberalization period; in 1979 and early 1980, Japan actively manipulated its capital account—virtually cutting off capital outflows and borrowing heavily abroad—to finance the huge current account deficits which it ran for a period after the second oil shock.

Beyond these interest rate and capital liberalization elements, both of which can be justified in straightforward economic terms without searching for devious motives, I find nothing which even approximates Japanese "manipulation" of the yen at present. Whereas I have found evidence of such manipulation in the past, as noted, I see no consistent pattern of such endeavors. Indeed, Japan's current account position has been weaker over the last 10 years than our own or Germany's. Moreover, there have clearly been periods when Japan actively sought a stronger yen. As in the area of trade policy, more narrowly defined, it thus seems unlikely that we can trace a significant part of Japan's success to policy fine-tuning—in this case, of the exchange rate—by its governmental authorities.

A PROGNOSIS AND PROPOSED POLICY PACKAGE

However, there remains an urgent need to correct the dollar-yen relationship. It is conceivable that the needed correction will take place on its own:

A continuing decline in world oil prices should strengthen the yen (and other currencies) against the dollar, as the two upside oil shocks weakened them considerably.

The severe deterioration in the U.S. trade and current accounts will become increasingly evident to the market over the coming months;

Renewed concerns about a revival of inflationary pressures in the United States, stemming from the huge budget deficits foreseen through the decade and the allegedly excessive expansion of money supply by the Federal Reserve, could weaken the dollar.

Moreover, the (relatively brief) history of flexible exchange rates teaches us that currency "bandwagons" move very fast once they start rolling. Virtually all observers agree that the dollar is substantially overvalued and the yen substantially undervalued, in terms of the underlying "fundamentals." If the market came to believe that the trend of dollar strength of the past 2 years had finally changed, it could very quickly push the yen up quite substantially.

However, there have been several false starts during the past year—when the yen (and other currencies) started to strengthen, only to fall back to (and beyond) their previous lows. The latest yen movement stalled at just under 230:1, leaving the yen considerably undervalued and remedying only about one-half the competitive imbalance. And we are in a race against time: protectionists trade pressures could well overwhelm our political process in 1983 or 1984 absent clear, full and sustainable correction of the currency misalignment which promises within a finite period to restore some modicum of equilibrium in economic relationships between the two countries.

It would thus seem prudent to adopt some or all of the following measures as soon as possible, inter alia to restore proper exchange rate relationships among the dollar, yen and other key currencies:

Further substantial reductions in U.S. interest rates.—With the decline in recorded U.S. inflation to very low levels, short-term rates need to decline by at least another 200 basis points. In addition to its essential role in encouraging recovery of the domestic economy, this step would do far more than any other policy action to promote the needed correction in the dollar exchange rate. The key policy step to this end is of course decisive action to reduce the huge outyear budget deficits, perhaps along the lines suggested in the recent Bipartisan Budget Appeal launched by five former Secretaries of the Treasury and Peter G. Peterson.

Aggressive foreign borrowing by the Government of Japan and its parastatal entities.—(Export-Import Bank of Japan, Long-Term Credit Bank, etc.), with the proceeds converted immediately into yen to strengthen the currency (and to help finance Japan's big government budget deficit).

Temporary limitations on capital outflows by Japanese institutional investors, such as the insurance companies and banks, carried out informally via "administrative guidance" (as in 1979, when such outflows fell to zero for some quarters).

Joint intervention in the exchange market by the United States and Japanese (and perhaps European) *monetary authorities* once the trend was clearly turned, to accelerate the pace and extent of the currency movement. The authorities could let it be known that their intervention was based on a common view that substantial changes were needed in existing rates and that they were determined to see that such changes occurred, such steps would be the mirror image of the concerted international actions taken to strengthen the dollar in late 1978. In addition, such action would represent an important milestone toward constructing a "target zone" system of cooperative international mangement of monetary relationship—which is needed to avoid further replications of the three episodes of dollar-yen misalignment during the past 15 years.

It is also essential to note what policy should not do. The erection of new trade barriers in response to this monetary problem would be a grave mistake, which I believe has already occurred in the steel industry, but which will inevitably be proposed—perhaps in the form of a U.S. surcharge on all imports from Japan, or a Japanese surcharge on all its exports—with increasing frequency if the monetary imbalance is permitted to continue to fester.

It would be a policy mistake because, given the present level of economic difficulties around the world and the degree of economic tension among the major countries, such action by the United States (especially) could trigger extensive trade conflict and go far toward destroying the GATT system which has been so central to postwar prosperity and world peace. It would also be a mistake for purely technical reasons because new controls, far from solving the problem, would probably intensify it. Their promise to improve the U.S. trade balance would tend to strengthen the dollar further in the exchange market, offsetting any "gains" from the controls themselves and in fact penalizing all American industries and workers (including those who sought protection in the first place). Despite the magnitude of the problem, new trade restrictions have no place in its resolution.

CONCLUSION

Needless to say, this package would require some important policy changes—including on the part of the U.S. administration. The administration simply must face the basic inconsistency between its (correct) devotion to free trade, at least in principle, and its (incorrect) devotion to laissez-faire in the currency sphere—an inconsistency which derives from the fact that exchange rates have a major impact on trade flows but are themselves frequently determined by factors unrelated to trade or current account developments.

The administration's failure to deal with the currency problem has in fact brought us the risk of an outbreak of protectionism not seen in this country since 1930. Overt action on exchange rates, and indeed on the functioning of the international monetary system, will almost certainly be essential to preserve an open trade policy for the United States and hence for the world as a whole—as well as to avoid continuing severe costs to our own economy, particularly concerning jobs.

The cardinal issue remains the need to understand that the overvaluation of the dollar, particularly vis-a-vis the yen, has an enormous impact on trade and on the U.S. economy. Its impact on trade policy, and on overall relations between the United States and Japan, has already been substantial and could become devastating. The Committee is to be heartily congratulated for holding these hearings to highlight the problem and to speed its resolution.

The CHAIRMAN. Thank you very much.

Just for a point of clarification on your point of disagreement with Mr. Morgan—Mr. Morgan used this as an example of what may be necessary for shock effect. Is he really in a sense being realistic about the fact that something drastic may be done if steps are not taken by the Japanese to help work with us to correct the present situation—that something may come out that would be worse unless orderly steps could be taken by both governments to rectify the current situation, which I think the Congress, the American people, organized labor and business consider intolerable at the present time?

Mr. BERGSTEN. I would have a twofold response to that, Mr. Chairman. I think the first step—and again, this is agreeing fully with Mr. Morgan—is for our own Government to declare it a problem and indicate its willingness to do something about it. I frankly have confidence that, when that happens, the Japanese will be ready to cooperate. So we have to be willing to move first, and that is likely to bring them along.

But it is still possible, I would agree, that shock treatment might be needed. If so, I would go for shock treatment in the monetary markets. I would rather start buying yen in the exchange markets to push that currency up, if it comes to extreme steps of that nature, rather than put on an import surcharge, which is technically deficient for the reason that I mentioned and could have much wider ramifications in the trading world than I would want to see.

The CHAIRMAN. Would you concur with Mr. Morgan in his conclusion that the IMF Articles of Agreement do relate to a country's policies that affect exchange rates when it appears to be an unfair competitive advantage, and that we should request the IMF—that our Government should request and we certainly would back up that request—that they take a look at this Japanese exchange rate relationship?

Mr. BERGSTEN. I certainly would support that, Mr. Chairman. I think the IMF has been somewhat derelict in fulfilling its responsibilities over the last couple of years in the face of these big currency misalignments. Again, however, I would have to note that it is not only a yen undervaluation. It is also a dollar overvaluation. So if the IMF starts looking at people, it is also going to look at people here in Washington.

The CHAIRMAN. Would it have a good psychological impact and also have an effect on the market factors if the IMF would undertake such a study and review and announce that they were going to do so?

Mr. BERGSTEN. Yes; I think it would. There has been much discussion over the years as to how the IMF can effectively carry out its mandate for surveillance of the international economic exchange rate system, under the Articles of Agreement.

One possibility that has been frequently discussed is publicity. The IMF, as you suggest, could have an effect simply by saying it is looking at a problem. It certainly could have an effect by indicating to a certain country that it was about to release some judgments about that country's policy unless the country moved, and then even if the country did not move and the data had to be released that would have an effect.

So there is a series of steps that the IMF could take to carry out its surveillance responsibilities, which I think it should be doing.

The CHAIRMAN. Thank you very much. I do not want to delay you, Mr. Mathis, the anchorman in this distinguished panel. You can comment on both the previous testimonies if you wish, but the full text of your statement will be incorporated into the record and any summary that you would like to give of it we would be pleased to have.

STATEMENT OF F. JOHN MATHIS, VICE PRESIDENT FOR INTERNATIONAL ECONOMICS, CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO., CHICAGO, ILL.

Mr. MATHIS. Thank you very much, Mr. Chairman. It is a pleasure to appear before this distinguished committee.

I am John Mathis, vice president and international economist with Continental Illinois National Bank & Trust Co. of Chicago. It is the seventh largest bank in the United States and it is primarily a corporate bank. That is, we work with corporate customers as opposed to retail business.

Let me summarize three major areas that my formal statement refers to. In the first part I tried to determine an equilibrium value for the yen, if one can be determined, and the conclusion is that no, one can be determined.

We have noticed that there is an increasing lag that occurs between adjustment of exchange rates to changed fundamentals and that expectations are playing an increasing role in that adjustment process rather than fundamentals.

A second part of the paper focuses on the Japanese-German foreign exchange movement comparison vis-a-vis the U.S. dollar, trying to show how these two countries move differently or together. We caution, a bilateral comparison is difficult in the first place and, as we heard in the earlier testimony this morning, not always the best approach. It may result in misleading results. But, nonetheless, the comparison seems to show that the Japanese yen and German mark have not moved that much out of alignment with each other.

The third part focuses on general policy guidance to accomplish national objectives that are pursued by the Japanese, particularly commenting on window guidance and administrative guidance. In this part essentially the conclusion is that no matter what form of short-term policy adjustments the Japanese Government may take, whether with respect to the exchange rate or with respect to trade barriers, that that can be offset by general, broad policy guidance at the administrative level.

Let me now try to respond specifically to a list of questions that were sent out with the notice of the hearing. First of all, there is a general perception among foreign exchange managers that the yen is misaligned. At the same time, foreign exchange markets have not corrected that misalignment, which means that while the perception is there something is preventing them from taking a position to cause the exchange market to reverse itself.

That cause, we do not feel, is intervention by the Japanese Government. Total intervention as near as we can measure, last year was about $6 billion. There are about $4 billion in transactions daily in Japanese yen. So surely that did not influence the exchange rate of the currency. We can find, therefore, no specific evidence to prove that the Japanese did intervene.

Second, we cannot formally identify what is an equilibrium value for the dollar. There are two problems. One is with the specific date of when you start to measure, the base date of the currency. You have to assign a base value and then you can measure from that point. But we cannot identify a good base period. Second, theories conflict in coming up with a specific solution to the problem of what is the equilibrium value of the dollar.

Second, since 1979 there has been a major change in the direction of exchange rates as the dollar strengthened dramatically. In my presentation I identify two periods. The total period covered is 1970 to 1982, but beginning at the end of 1979 or early 1980 there was a change, a major change, in the direction of exchange rates. Prior to 1980, exchange rates were moving in the direction that generally everyone expected them to go, with the yen strengthening, the mark strengthening against the dollar.

Now there seems to be some disagreement as to that direction of movement. Since 1980, there was a dramatic improvement in the value of the dollar which tended to weaken the other currencies, and this seems to be primarily due to interest rate considerations in the United States. But there were other factors also, such as that the dollar became viewed as a haven currency because of political problems in Eastern Europe, because of debt problems in developing countries, and a number of other factors which just made the dollar, for political reasons, seem to be a very desirable currency to hold.

Third, it is particularly difficult to separate exchange rate impact from what I call the demand impact since the world has been in recession since 1977. Each product viewed in international trade would have to be examined separately and careful consideration be given to quality differences to identify if the yen was misaligned or out of alignment. This is extremely difficult to do.

The purc' asing power parity theory, which is used to determine exchange rates, does not effectively give you an answer as to what the dollar's value should be against other currencies. The U.S. trade deficit with Japan has played an important role in the rise of protectionist sentiment, but not specifically the yen-dollar exchange rate.

There were other factors that contributed to the emergence of a trade surplus by Japan. The United States does run a trade surplus with Western Europe and with the developing countries at the same time that we have a deficit with Japan. As Japan does depend on

imports from other countries to produce the products which it sells to the United States.

Focusing solely on bilateral balances really does not give you a clear indication of what the exchange rate should be. As in the case of Germany, an appreciation of an exchange rate does not guarantee the correction of a trade deficit or a current account deficit or even a basic balance deficit, which takes current account and adds long-term capital flows.

Exchange rates just do not automatically correct the situation. One must also focus on quality differences and product differentiation, which do exist in the different countries.

We can find no clear evidence of support, in the case of Japan, that it is intervening in the exchange market to establish a target exchange rate. What we can find is that Japan does have a different philosophy concerning exchange rate management. Japan's intervention in the exchange markets occurs by controlling capital flow so as to dampen exchange rate fluctuations so as to smooth volatility.

The objective is to reduce current account deficits but also to reduce current account surpluses. Japan does not appear to control the long-term direction of the yen through foreign exchange intervention. However, government-business relationships and trade restrictions do have a long-term impact on the exchange value of the yen because they influence the current account balance. It is an indirect influence, not a direct one. An extreme example of this is the samurai lease aircraft financing scheme which I describe in my formal statement.

Since 1979, high U.S. interest rates have been highly correlated with the strengthening of the dollar against the yen and other currencies. A reduction in U.S. interest rates has helped to facilitate realignment of exchange rates as the dollar has weakened. There has been some correction that has taken place with respect to the exchange value of the dollar and the yen.

However, there are so many other factors that go beyond just trade relationships between the two countries that have had an impact on the exchange rate of the dollar. Some of those I have mentioned already. Political considerations, very slow growth in Japan—a disappointingly slow growth, the smaller than expected current account surplus in Japan have all tended to benefit the value of the dollar and have not resulted in a stronger yen.

Many of the problems that have been faced by exporters so far reflect recession, worldwide recession. There has been little or no growth in the volume of world trade in 3 years. As global recession ends and world trade growth picks up, export price competitiveness will become more apparent and we anticipate that because of that the United States will experience no growth in exports and will experience a very sharp $15 to $20 billion rise in imports, and this will cause the U.S. trade deficit to worsen.

This is part of a normal business cycle development as an economy pulls out of a recession. This is in fact what happened back in the period 1975–76, when each year we experienced a $20 billion deterioration in our trade deficit in those 2 years. But thereafter we did experience some improvement as the business cycle continued.

More stable exchange rates may have avoided some of the problems we are confronted with today, such as the potential for a sharp deterioration in the U.S. trade balance and also for the yen, which is considered to be undervalued.

As I mentioned, with respect to the speed or rapidity of adjustment, the evidence continues to be confused by the fact that it is becoming longer. Currencies are more impacted by expectations, less so by fundamentals. Increasingly, foreign exchange markets are influenced by "chartist" and "momentum models" which tend to remove the market from fundamentals. Therefore the market does not respond quickly to a formal statement or declaration that the currency is undervalued or overvalued as we saw recently when Secretary Regan made a statement that the dollar was in fact overvalued.

Complete correction may take time, but it is a dynamic process and it is a very slow process. Specific steps to recommend for the United States and Japanese Government to relieve the problem require that we identify what is the problem. The problem is the policies that cause trade distortions, such as government-business relationships, influence the current account balance and, therefore, influence the exchange rate.

The problem is not one of an undervalued yen. It is one where government policy in a broad sense has been pursued with the general purpose of enhancing the growth of the Japanese economy through export promotion. It is that mindset that must be altered, that must be changed. Even if the exchange rate were appreciated in the case of Japan, window guidance or administrative guidance might circumvent the effects of a stronger yen.

The CHAIRMAN. Mr. Mathis, I wonder if I could suspend your testimony now. I mentioned at the outset that the Canadian Minister of Energy and his party would be arriving. They have arrived. They are listening attentively to your testimony and I know they would prefer to do that than talk about reducing Canadian energy prices, but I will ask that we adjourn for a brief period now so that we can pick up with that appointment.

Unfortunately, we have not been able to find another Senator that has been free. So we will adjourn for a few minutes.

[Recess.]

The CHAIRMAN. Mr. Mathis, if you could resume, please. I am sorry that took a little longer than I thought it would, but the price is coming down and soon.

Mr. MATHIS. Thank you, Mr. Chairman. I just have two final points to make. One of the major points is that just adjusting an exchange rate does not resolve the problem, that there are more fundamental problems that relate to the government-business relationship in the case of Japan, where their overall objective of policy is oriented toward promoting export sales to support domestic economic activity. Therefore, even if you did adjust the exchange rate, window guidance or administrative guidance would be used to circumvent any exchange rate adjustment to accomplish these long-term objectives.

Therefore, I think attention must be focused on a modification of these objectives to make them participate more fully in the international financial community.

Finally, for the United States part it must not become protectionist. Any sort of protectionist pressure at this point would frustrate the U.S. economic recovery as well as jeopardize not only relationships with Japan but also with the developing countries of the world that are suffering from financial problems. It would also only further delay economic recovery of the other major industrial countries of the world upon which we depend to buy our exports as well.

The United States must work more directly on changing this commitment, this mindset of the Japanese that is so self-motivated. There must be a better integration of economic policies among countries. U.S. economic policies must not deviate so dramatically from industrial policies in other countries without being aware of the consequences.

The factors that precipiated such different U.S. policy reactions were really problems that we generated internally to start with and somehow we must better anticipate those problems, particularly inflation, before allowing ourselves to have to change policies so dramatically, which tends to have a whiplash effect on international financial markets since the dollar is the key currency both from a reserve standpoint and international transaction standpoint.

How to do this? I think one shortfall has been the General Agreements on Tariff and Trade [GATT] negotiation process. Somehow that process must be beefed up and address on a more balanced scale window guidance, administrative guidance, in the case of Japan and the non-tariff barriers that do exist. The annual meeting of GATT that was concluded last year I thought was very disappointing in that it did not address these issues.

Thank you very much.

[Mr. Mathis' prepared statement follows:]

PREPARED STATEMENT OF F. JOHN MATHIS

I am John Mathis, Vice President and Chief International Economist with the Continental Illinois National Bank and Trust Company of Chicago. The Continental Bank is the seventh largest commercial bank in the United States with assets of $43 billion, encompassing international activities exceeding $10 billion around the world. Continental Bank is one of the largest corporate banks servicing the needs of corporations in the United States and abroad.

The time period focused on in this statement covers the period 1970 to 1982. We begin in 1970 because that is when the shift from fixed exchange rates to more flexible exchange rates began. Shortly thereafter the United States abandoned the gold standard, devalued the dollar and signed the Smithsonian Agreement. This period can be divided into two parts: from 1970 to 1979 during which time the dollar was devalued twice and remained a depreciating currency, and 1980 to 1982 when the dollar strengthened dramatically during the imposition of highly restrictive monetary policy in the United States.

SUMMARY CONCLUSIONS

1. There is a general perception among U.S. foreign exchange managers that the yen is misaligned. We can find no specific evidence to prove this point and we don't think it is possible to prove the point because of deficiencies in foreign exchange rate theory.

2. Since 1979 there has been a major change in the direction of exchange rates as the dollar strengthened dramatically. Evidence suggests that this was due to an overvalued dollar.

3. It is particularly difficult to separate the exchange rate impact from the demand impact since the world has been in recession since 1977. Each product would have to be examined separately and careful consideration given to quality differences. The U.S. trade deficit with Japan has played an important role in the rise of protectionist sentiment in the United States but not specifically the yen-dollar exchange rate.

4. We can find no clear evidence to support the case that Japan is intervening in foreign exchange markets to obtain a specific targeted exchange rate.

Japan does have a different philosophy concerning exchange rate management from the United States. Japan's interventions in exchange markets occur by controlling capital flows so as to dampen exchange rate fluctuations and reduce current account surpluses and deficiits. Japan does not appear to control the long-term direction of the yen through foreign exchange intervention.

However, government-business relationships and trade restrictions do have a long term impact on the exchange value of the yen because they influence the current account balance. An extreme example is the samurai lease aircraft financing scheme.

5. Since 1979, high U.S. interest rates have been highly correlated with the strengthening of the dollar against the yen and other currencies. The reduction in U.S. interest rates has helped to facilitate a realignment of exchange rates as the dollar has weakened. However, other factors, such as international financial problems, political uncertainties, and slow growth in Japan, have benefited the dollar's exchange value.

6. Many of the problems faced by exporters so far reflect weak demand due to recession overseas and debt problems in developing countries. As global recession ends and world trade growth picks up, export price competitiveness will become more apparent. We anticipate no growth in U.S. exports and a $15 to $20 billion rise in imports to push our trade deficit toward $60 billion this year. Recently, a report from the governments of major industrial countries indicated that foreign exchange intervention would work if accompanied by appropriate domestic policies. More stable exchange rates may have avoided some of the trade distortions faced today.

7. Empirical evidence indicates a lengthening delay in exchange rate adjustment specified by theoretical models. Some appreciation of the yen has recently occurred as U.S. interest rates were reduced. Complete correction may take place but it may take considerable time.

Specific steps to recommend for United States and Japanese Governments to alleviate problem:

The problem is: policies that cause trade distortions such as government-business relationship to influence current account balance i.e. samurai lease aircraft financing scheme and other more permanent impact restrictions and export subsidies. "Window" and "administrative" guidance must be used less blatently to circumvent economic agreements.

The United States for its part must not become protectionist but should continue pressure on Japan to remove barriers to trade. The United States should also be more sensitive to the international ramifications of its policies and attempt to reduce the erratic nature of these policies. Finally, consideration should be given to periodic foreign exchange intervention to help stabilize the dollar, particularly when U.S. economic policies deviate dramatically from those in other major industrial countries.

INTRODUCTION

Perhaps the most serious threat to future international financial stability and the recovery of world economic growth is rising protectionist pressures. The source of this pressure in the United States, as well as in other countries is the current high level and persistence of unemployment. In the case of the United States, evidence of strong import penetration by Japanese exporters is overwhelmingly evident and has clearly contributed to this unemployment. Much attention in this regard has been focused on the large historical trade deficit the United States has had with Japan for some time. Japan uses its trade surplus with the United States and Europe to pay for her large food and raw material imports from other countries who in turn purchase U.S. products.

The United States has long been a strong supporter of free trade and the benefits of such a policy are well known to us all, but unfair trade practices in other countries must be removed. This must not be done through the imposition of our own protectionist barriers but instead we must continue to work to encourage others to remove their barriers. If the United States imposes additional protectionist measures at this time, even if they are in support of a longer-term objective of freer trade, the cost will be high to us all. Economic recovery may be curtailed and the foreign debt servicing problems of developing countries severely aggravated. The increased interdependence of world economy requires

that world trade experience a sustained expansion. In this respect maybe the United States should have followed Japan's example of stabilizing the yen by stabilizing the dollar, instead of allowing U.S. domestic policy to have such a harsh impact on foreign economies. This might have left the yen much stronger than it is today.

Attempting to pursuade another country's exchange rate is just another form of protectionism. It is not a permanent solution in itself to unfair foreign trade practices that a country may be following. Foreign trade issues are extremely emotional and may become particularly vocal in specific cases. But while specific cases are particularly relevant as indicators of changing conditions, care must be taken not to let them overwhelm our long-term objectives in support of free trade. It is often difficult, even in specific cases to distinguish between unfair trade practices and stronger competition resulting from more efficient productivity due to technological advance or superior quality of the foreign product. Prior to the 1980 world recession, Germany had been able to maintain strong export growth and its share in world trade despite significant appreciation of the mark, and there is no reason to believe the same could not be true for Japan as the yen appreciates.

There is widespread discussion that the Japanese Government has been unwilling to assume greater international responsibility commensurate with its rapid rate of economic development. While in general, this reluctance may emanate from the government's desire to insure the long-term viability of industrialization in the country and maintain strong markets for Japan's growing output potential, there are two more specific reasons for this heistance. First, Japanese Government agencies are unwilling to surrender any of their power over controlling the direction of the economy and they are unwilling to react quickly to the often changing economic policies of the United States and other industrial countries.

Economic policy management in Japan has as its long-term objective the support of continued domestic economic growth and improvement of the standard living. This objective is achieved through short-term policy adjustment but little fundamental change in the structure of international economic relations. Even where there have been changes in trade and capital regulations, administrative guidance may supersede all other policies in accomplishing Japan's long-term objectives. Arguing that the yen is undervalued may only precipitate short-term administrative guidance policy adjustments to strengthen the yen and not a more fundamental change in the rules that govern Japan's international relations. Besides, a stronger yen doesn't guarantee a current account balance. It is this fundamental "mind set" that must be addressed regardless of the particular immediate U.S./Japan trade picture.

Determination of the equilibrium exchange rate and recommendation of a particular foreign exchange intervention strategy are only temporary short-term measures. Intervention, according to the recently concluded Group of Ten study, will be effective only if it is based on the knowledge that policies will be pursued that will steer the fundamentals in a direction that will validate the intended movement of the exchange rate. It is for this reason and because the U.S. Government believes that intervention does not work that it abandoned such a policy. The rules of the game under which Japan manages its international economic relations should be changed in favor of freer trade since simply adjusting the yen does not address the roots of the problem. But the self-interest policy objective requires that the long-term benefits of structural policy changes must be clearly identified to Japan or that the costs of not pursuing such a policy are high.

The following sections analyze the determination of an equilibrium exchange rate, compare the movement of the Japanese yen to the German mark and examine policies influencing Japanese financial transactions.

DETERMINATION OF AN EQUILIBRIUM VALUE

Economic theory identifies the trade, current account, and balance of payments adjustment toward equilibrium as being a long term process. Theory does not require that each account be in balance with every country all the time or even over longer periods. These developments are a function of the level of a country's economic development, its technological or productive capacity, and its natural resource endowment, as well as the country's economic policies. Thus, the fact that the United States has recorded a consistently large trade surplus with Western Europe or with developing nations should not be considered a problem the United States must correct, any more than we should feel it is necessary

for Japan to reduce its surplus with the United States unless both the United States and Japan are interfering with trade flows or exchange rates.

Several avenues of analysis are possible in approaching the question as to whether or not the yen is undervalued and if this has been a direct result of actions by the Japanese Government. One approach is to attempt to estimate the equilibrium value of the yen. This is not an easy task. The first major problem encountered is choosing a base period from which to measure the relative changes in currency values. This choice is arbitrary but also complicated by the fact that most exchange rates were artificially fixed until 1971. However, even assuming a base year could be agreed upon, the theory on exchange rate determination is not clear as to the best approach to determine an equilibrium value.

A second problem is that although noticeable advances in the theory of exchange rate determination have been made in the past decade there are still shortcomings. Purchasing Power Parity theory (PPP) argues that exchange rates move over time so as to offset divergent movements in national price levels. PPP theory leaves open two questions: channels through which this relation between inflation differentials and depreciation will come about, and the extent to which PPP is a complete determinent of the exchange rate—are there possibilities for trend deviations over time? Analysis has shown one possibility for systematic deviation arises from the existence of nontraded goods. A second source of systematic deviation deals with effect of net capital flows or current account imbalance.

A more contemporary view of PPP recognizes in the short and perhaps even in the long run there is substantial scope for product differentiation or quality differences. Price adjustment is no longer a matter or arbitrage but rather is a question of substitution. Thus, deviations from PPP are not only possible but may persist for some time. The monetary approach to exchange rate determination argues that domestic prices are fully flexible but are linked to world prices by PPP. Given the nominal quantity of money, any variations in the demand for money must be offset by compensating changes in the level of prices and thus in the exchange rates. But since the foreign price level is determined by foreign money demand and supply, exchange rate determination is dependent on relative money supplies, velocities, and real incomes in the two countries—a country's exchange rate will depreciate if its nominal money stock rises relative to that abroad, other things being equal. The BIS recently indicated that persistent large swings in currencies raises skepticism about PPP approach both as a theoretical device and as a basis for longer-term forecasts.

The balance of payments theory of exchange rates argues that the exchange rate adjusts to balance receipts and payments arising from international trade in goods, services, and assets. Under this theory, exchange rates depend on interest rates, activity levels, relative price levels, and the exogenous determinants of the composition of world demand. The balance of payments model does not assume perfect capital mobility but instead assumes that capital movements take place over time in response to interest rate differentials, divergences in after-tax profit possibilities, and potential risk factors.

The modern macroeconomic approach to exchange rate determination argues that the exchange rate enters the macroeconomic framework of interest rate and output determination because changes in exchange rates affect competitiveness. Depreciation acts much in the same way as fiscal policy by affecting the level of demand for domestic goods associated with each level of output and interest rates. This approach, however, does not include exchange rate expectations, and does not consider the impact of depreciation on domestic prices and the real value of money stock. Also, it is not a dynamic model in the sense of trade flows and lags. These problems are to some extent taken into account by the portfolio balance model which argues that equilibrium exchange rates depend on relative asset supplies or substitution possibilities between domestic and foreign assets. The difference between monetary and portfolio balance models as that both assume perfect capital mobility but differ in that the former assumes perfect substitutability between domestic and foreign assets while the letter does not.

ADJUSTMENT PROCESS TO EQUILIBRIUM VALUE

Most modern exchange rate models are not dynamic enough to identify the period of adjustment it takes for a currency to arrive at an equilibrium value. In other words, there are indeterminent lags which may last for some time—several years—before an exchange rate moves in the direction of equilibrium.

This has been evident in several empirical testings of theoretical models. To some extent this adjustment lag has been complicated by the initiation of foreign exchange futures and options markets as currency speculators have introduced forecasting techniques—charting and momentum models—which have little bearing on economic fundamentals. Thus, there is serious question as to whether contemporary foreign exchange theory can provide conclusive evidence on the equilibrium value of an exchange rate.

According to the Bank for International Settlements, "it follows that, as in all asset markets, exchange rate determination left to itself is dominated by expectations. It is, then, perfectly conceivable that with the strength and duration of certain kinds of expectations exchange rates can move to levels, for quite long periods, that will produce an unsustainable situation in the domestic markets for goods and services. This is what is called 'overshooting'. At a certain point the 'unsustainable' nature of the current account, or of the domestic markets, will become so obvious to market participants that they will overwhelm the exceptional forces working in the other direction; from that point onwards there will be a reversal of the exchange rate movements, with the distinct possibility of 'overshooting' in the opposite direction." This is a description of what is happening in Germany and what could happen in Japan.

BALANCE OF PAYMENTS DEVELOPMENTS—MARKET INTERVENTION

A second approach to the issue of the appropriate value for the yen would be to ascertain if there was foreign exchange market intervention by the Japanese Government. This approach is also complicated because detailed information on Japanese Government foreign exchange transactions are not readily available. (Nor is such information available for the authorities in the United States and other major industrial countries.) Intervention may be accomplished in many subtle ways which may not be easily detectable as influencing an exchange rate.

A review of the literature on Japanese foreign exchange market intervention, measured in several different ways, reveals little evidence of intervention to move the actual rate to a targeted rate. There is evidence to support the argument that the Japanese Government has intervened to "lean against the wind" of market pressures which have caused dramatic fluctuations in currencies in recent years. Discussions with the Bank of Japan confirm that about $6 billion in international reserves were used during 1982 to cushion the weakening in the yen. This is a relatively small amount in terms of the total foreign exchange transactions in yen during any one year, and amounts to only about 3 percent of the total dollar value of Japan's exports of goods and services in 1982. Such intervention generally tended to reduce the competitiveness of Japanese goods.

The use of international reserves to maintain an undervalued yen is not clear. Depending on the period used to measure changes in international reserve holdings different results are obtained or expected. Over the period 1970 to 1982, for example, United States and Japanese international reserves less gold rose by an equal current of $19 billion to a total of $23 billion for each country. Much of the U.S. increase occurred since 1979 while Japan's increase took place in the early and mid-seventies. Germany's reserves rose a larger $35 billion to almost $45 billion. However, this is not the best way to measure reserve adequacy. A better way is to measure it against the number of months of imports reserves will pay for or cover. This measure shows that since 1979, the number of months of imports covered by reserves in Japan remained constant at 2.1 months (slightly below its 1970 level) while coverage declined in Germany but more than doubled in the United States to 1.1 months (slightly higher than its 1970 level). Thus, Japan's reserve adequacy, because of increased imports, is below Germany's but above the U.S. level and is little changed from 1970. Therefore, international reserve management is not a clear indicator that the yen has been kept undervalued.

A COMPARISON OF JAPANESE AND GERMAN EXCHANGE RATES

A third approach to identify if the yen is undervalued or the dollar overvalued because of U.S. economic policies, particularly high interest rates, is to compare the movement of the yen to the movement of other currencies, such as the German mark, against the dollar. This approach would help neutralize the impact of U.S. economic policy as it would be a common denominator for both currencies.

Focusing on the period between 1970 and 1982, the number of yen it takes to purchase $1 fell 31 percent while the number of marks to purchase $1 declined 34 percent. Thus, one mark would purchase 98.4 yen in 1970 and 102.6 yen in

1982 indicating a 4.3 percent appreciation of the mark against the yen. The mark has been somewhat more stable than the yen but this may be partly due to the efforts of the European Community to stabilize their exchange rates against the dollar with the eventual implementation of a formal arrangement in the EMS.

During the period 1970 to 1982, Japan recorded a cumulative $28 billion trade surplus while Germany had a $164 billion surplus and the United States experienced a $284 billion deficit. At the same time, Japan had a cumulative current account surplus of $33 billion while Germany recorded a $12 billion deficit again compared to a $4.6 billion U.S. deficit. In the case of Germany, the difference between the very large trade surplus and smaller current account surplus is accounted for by dividend, royalty, and interest payments to foreigners and unilateral remittances. Since Japan is more restrictive than Germany in allowing foreign investment, Japan does not have similar outflows. If Japan was more open to foreign investment and did have such outflows this would worsen Japan's current account deficit and argue for a weaker yen. The liberalization of foreign investment in Japan in 1980 increased capital inflows and raised the demand for yen but as these inflows grow they will result in increased service earnings paid to foreigners which will weaken Japan's current account as is the case in Germany. However, high U.S. interest rates in 1981–82 adversely affected recessions in Germany and Japan improving their current account balances.

The cumulative 1970–82 U.S. trade deficit with Japan and Germany is $88 billion and $19 billion, respectively. Meanwhile, Japan has accumulated a $13 billion trade surplus with Germany over the 12 years and, according to Japanese data a $48 billion surplus with the United States. The persistent Japanese trade surplus to some extent reflects the different nature of Japanese imports and exports. Japan's importation of raw materials and exports of finished goods permits a tremendous value added impact which is not experienced by the United States or Germany. Whether looked at from the United States or Japan's standpoint the bilateral cumulative trade surplus of Japan would tend to support a strong yen against the United States but also against the German mark. Between 1970 and 1980 the yen did appreciate almost 50 percent against the dollar and 27 percent against the mark but in 1981 and 1982 everything changed as the dollar strengthened.

A broader measure of a country's international position is the basic balance measure which adds long-term capital flows to the current account balance. It does not include short-term capital flows since these are believed to be erratic, and do not reflect a country's fundamental external position. The cumulative basic balance position over the period 1970 to 1982 showed a $27 billion deficit for Japan compared to a $57 billion U.S. deficit and a $9 billion surplus for Germany. This would imply that the mark should have strengthened against the yen and the yen against the dollar. This, in fact, is what happened although perhaps not as much as some observers would like. The direction and intensity of capital flows, short and long, would tend to be a key determinant of the degree of exchange rate adjustment.

The capital account (which includes direct investment, portfolio investment, other long- and short-term capital flows) showed a cumulative 1970–82 deficit of $243 billion for the United States, a $22 billion deficit for Japan and a $9 billion surplus for Germany. The cumulative $22 billion capital account deficit for Japan reflects a movement out of yen denominated assets and should weaken the yen particularly relative to the German mark which experienced a capital surplus. However, the very large U.S. capital account deficit, which was 10 times larger than the Japanese capital account deficit, implies that the dollar should be weak against the yen, at least during this period. Massive capital inflows would be necessary to indicate a stronger yen. Japan restricted capital inflows until 1980, but in that year there were substantial inflows which have since moderated. Liberalization of Japanese capital controls has enabled outflow to take advantage of high U.S. interest rates but as these fall funds should move back to Japan.

Capital flows, unless limited by restrictions are a function of interest rate differentials as well as other factors beyond a country's immediate control. Thus, one method of controlling capital flows would be for Japan to manage interest rates to make investment in yen assets attractive or unattractive. During the period 1970 to 1976, Japanese representative money market interest rates were consistently above U.S. interest rates by about 2 percent. From 1978 to 1982, Japanese rates were about 6 percent below U.S. interest rates. This switch reflected the substantial increase in U.S. interest rates (from a 6.6 percent average 1970–76

to 12.7 percent from 1978–82—although much higher levels were reached in 1980–81) while Japanese rates fell only slightly (from 8.7 percent average during 1970–76 to 7.1 percent between 1978 and 1982) reflecting an economic slowdown.

Thus, from a nominal interest perspective it would appear that the U.S. interest rates contributed significantly to the weakening of the yen and other currencies against the dollar since 1979. Japanese interest rates also averaged about 1 percent above German interest rates between 1970 to 1976 but were 1 percent below German rates from 1978 to 1982. This was reflected in a strengthening of the yen against the mark during the mid-seventies and it even continued stronger until 1981. Japanese interest rates have been low in recent years because inflation is low and economic growth has slowed from its high historic average. Raising Japanese interest rates to strengthen the yen would be unjustified since Japan has low inflation and, by past standards, low growth.

Measured on a consumer price basis, real interest rates were lower in Japan then in the United States from 1970 to 1982 except between 1978 and 1980, while in Germany they were consistently positive and higher than in the United States and Japan, except in 1982. Measured on a wholesale price basis, real interest rates again averaged below real rates in the United States and Germany, although there were many years when real returns were higher than in each of the other countries. This data would reinforce the argument for a strong mark based on the surplus basic balance account in Germany but would tend to offset the effect of a smaller cumulative basic account deficit that Japan recorded compared to the United States. The data does not clearly explain why the yen moved in tandem with the German mark. Even when exchange rates are looked at on a real effective basis (measures the trade-weighted value adjusted for inflation differentials) between 1970 and 1980 the mark had appreciated most, followed by the U.S. dollar and then the yen.

Beginning in 1980, the dollar leads the mark in terms of real effective appreciation while the yen is substantially weaker than the mark—21 percent compared to only 2 percent in the earlier 1970–80 period. Thus, U.S. monetary policy changes would not explain the full story regarding the yen's weakness particularly when compared to the German mark.

Other special factors that have contributed to the dollar's strength or yen's weakness since 1979 include the increased role of the dollar as a haven currency. However, this should have affected the yen and mark equally or even weakened the mark more because of the Polish situation and eastern European debt problem. Another possible explanation for the weak yen recently was that the Japanese current account turned out less strong than expected while Germany's improved. Despite depressed imports reflecting the Japanese economic slowdown, poor export performance, including sales to the United States, accounted for the shortfall. This development reflected weak economic performance abroad but as recovery takes hold in the United States and Europe, export sales should recover depending on protectionist pressures levied against Japan. If factors supporting a strong dollar are removed then the yen will strengthen.

Capital flows, particularly long term, have affected the yen exchange rate since 1979 following the liberalization of foreign exchange controls as net long-term outflows rose steadily as Japanese investment abroad increased while foreign investment in Japan slowed last year. This slowdown reflected dissatisfaction with Japan's sluggish growth performance. Since August of last year, however, net long-term inflows have improved, reflecting increased foreign purchases of Japanese securities and Japanese sale of their holdings of foreign securities as U.S. interest rates had fallen. More recently, the Bank of Japan has maintained the discount rate because of the weakness of the yen and despite the depressed level of economic activity domestically. Governor Mayebawa of the Bank of Japan stated that the "yen had not shown a rising trend firm enough to justify cut." This has tended to benefit capital inflows as the real interest rate differential against Germany favors the yen, although both currencies are at a disadvantage relative to U.S. real interest rates.

The gradual narrowing of this differential with the United States and improved current account surplus should help the yen to appreciate. The imposition of capital controls or exchange market intervention would be contrary to U.S. efforts to liberalize the Japanese market. With capital inflow low, the maintenance of relatively high interest rates to strengthen the yen would require increased fiscal stimulus but as in the case of the United States, the budget deficit is a high and rising percent of GNP—almost double the U.S. level. Thus, the United States would surely not recommend this policy since it would probably

weaken confidence in Japanese economic management and weaken the yen anyway.

JAPANESE EXCHANGE RATE MANAGEMENT

In Japan the Bank of Japan (Central Bank) and the Ministry of Finance use "window" and "administrative guidance" in addition to formal rules to augment regulatory control over the banking industry. A chronological recounting of shifts in the level of Japanese bank activity in international markets during the 1970's provides evidence of the Japanese authorities' acumen in harnessing that activity to support the balance-of-payments objectives of Japanese foreign economic policy. (A. Spindler, Brookings Institution, International Banking and Foreign Policy, 1983.) From 1970 to 1973, the combination of growing Japanese trade surplus and official reserves figured decisively in the government's decision to encourage major Japanese banks to make foreign currency loans in the Euromarket to stimulate capital outflow.

From the end of 1973 through 1975, as Japan's current account swung into deficit the government severely restricted foreign currency loans to foreigners and provided banks with incentive to import capital. From 1976 through 1978, Japan's current account moved back into surplus and the authorities relaxed overseas lending by Japanese banks in both foreign currencies and yen. Simultaneously the Japanese government began moving huge foreign currency balances (from official reserves) to banks in the form of so-called hidden reserves."

In 1979, oil price increases again worsened Japan's current account deficit causing the government to suspend foreign lending by banks except for trade related financing. The government also took steps to attract OPEC funds to Japan. In March 1982, the Finance Ministry authorized Japanese banks to pay whatever interest rate they desire on free yen deposits from foreign government and international institutions. Diplomatic efforts were also taken to bolster the fund's collection effort. Finally, as Japan's current account improved during 1980, restrictions on overseas lending were relaxed.

Thus, the Japanese financial authorities have relied on Japanese banks' international lending and deposit-taking to achieve both net capital inflows and outflows instead of allowing the exchange rate of the yen to vary and correct changes in the current account balance. This approach keeps the control over how international financial developments impact their economy in the hands of the Japanese Government instead of in the market place. By stabilizing the exchange value of the yen to offset swings in the current account balance they make it easier for Japanese companies to plan long term by stabilizing earnings. Since Japan is so heavily dependent on imported raw materials a weaker yen which may benefit exports raises sharply import costs while a strong yen which cheapens imports curtails export growth. So exchange rate stability is particularly beneficial. This form of policy enables Japan to avoid structural adjustment and perpetuates other types of "window dressing" policies that eventually may undermine Japan's competitiveness.

One example of such a policy is the samurai lease aircraft financing scheme (A. Spindler Brookings Institution, International Banking and Foreign Policy.) "Several large Japanese banks assisted MITI with the design of an unusual international leasing plan to produce a largely cosmetic reduction in Japan's swelling current account surplus. Before the plans' termination in June of 1979 participating banks and leasing companies effected an improvement in Japan's statistical balance of payments, not only by stimulating capital outflows from the country, but also by reducing its current account surplus by nearly $1 billion through the promotion of imports. For their efforts the banks and leasing companies earned extraordinary profits."

Briefly the plan called for "Japanese-based financial institutions to provide lease financing for sales for high priced aircraft between parties in foreign countries." "The Japanese leasing company would acquire title to the airplane making it an import but the plane would be immediately used by a non-Japanese airline." "At the end of the lease agreement when the plane was fully depreciated, ownership would be transferred to the lessor for a token sum, perhaps $1 which then shows up as export revenue." Also, the financing for such transactions to the foreign lessor was well below the interest rates charged by U.S. leasing firms. The program ended only when the United States demanded that the same leasing arrangements be offered U.S. airlines and the International Monetary Fund changed its accounting practices concerning leases.

Thank you for letting me appear before you today.

The CHAIRMAN. Thank you very much.

I wonder if you could comment, Mr. Mathis, on the relationship that you feel—what the proper yen-dollar exchange rate should be. The figure of 200 yen per dollar has been mentioned. In your judgment, is this a so-called proper rate and how do you determine what a proper rate really is?

Mr. MATHIS. To be honest with you, I cannot tell you what the proper rate is. I have looked at this issue carefully and I have talked to a number of foreign exchange traders, the market participants, at numerous banks and asked them to give me a number. And again we do not come up with a common number.

They say they believe it is undervalued, but on the other hand, as I mentioned at the outset, the exchange rate market has not reflected that. It has not adjusted so as to indicate that it is an undervalued currency. Expectations which play an increasingly important role in exchange rate determinations have not supported the fact that it is an undervalued currency.

We are going through an adjustment process that has resulted in perhaps the dollar being an overvalued currency, and maybe that is the more correct way to look at the problem right now. The dollar is still the key international currency and policies that we took to reduce inflation, I think, are very beneficial and something that we do not want to give up just to have a short-term exchange rate adjustment right now.

It is something that we want to hang onto because it was a very harsh adjustment process. In the long term, those policies will improve our competitive position. Having a lower inflation rate, will enable domestic business to be more competitive and so, as to an economist, if I look at this from a longer-term standpoint, I feel that there will be self-correcting mechanisms that will cause the value of the yen to adjust at some point.

It seems that that adjustment takes longer now, and that is what is so frustrating to American business, which has to deal with it.

The CHAIRMAN. By the way, I will keep the record open for 10 days so that any amplification you would like to make of your comments can be made then; and we want to keep it open so that you can do that, because I intend to have this testimony printed and send it to the international agencies.

Certainly Secretary Shultz will be most interested in the problem and I know we will have requests from Japan for copies and we will make it available to Treasury and so forth in the administration.

Some observers do say that even if Japan were to drop all its trade barriers tomorrow the bilateral United States-Japan trade deficit would not be reduced significantly so long as the dollar remained at its present high value relative to the yen. Do each of you agree with that observation?

Mr. MATHIS. I feel that exchange rate changes are not immediately transferred into a trade balance or current account balance adjustment. I think the best example of this is the continued appreciation of the Deutsche mark up until 1980 during which time the Germans seemed to continue to gain or at least maintain their market share in world exports of manufactured goods and also seemed to experience continued rapid growth of exports.

There are just so many other factors that influence countries' trading relationships. It is difficult for us to say we should have a bilateral trade surplus or a smaller deficit with Japan. We have to look at it from the broader perspective of our overall relationships with all countries.

Mr. BERGSTEN. I disagree strongly with Mr. Mathis on that. Of course, it is right that we not look at bilateral balances; we look at global balances. But when you look at the record of the last 15 years, you see that exchange rate changes do produce in almost textbook fashion the adjustment in trade and current account balances that one expects.

It has happened twice in the last decade in the United States-Japan relationship. In the late 1960's and early 1970's, at the end of the Bretton Woods period of fixed exchange rates, the dollar became clearly overvalued and the yen became clearly undervalued. As a result, for the first time both the global and bilateral external positions of the two countries moved into a crisis stage.

After the currency realignments of 1971 and 1973, adjustment took place in almost textbook fashion well before the second oil shock. The United States was already back into current account equilibrium. Japan's surplus has disappeared, and the whole international economic framework, both monetary and trade, had been put very much back into order.

Again, after there was a more modest misalignment between the dollar and other currencies, including the yen, in the mid-1970's, correction had to take place. It was a very painful depreciation of the dollar that took place in 1977–78. Again, I say that with feeling, having been at the Treasury at that time.

But again, once it occurred, an enormous correction took place. Few people realize that from 1978 to 1980 U.S. exports grew at double the rate of world trade. We recaptured a share of world export markets for manufactured goods not seen since the late 1960's. We had a $60-billion improvement in our current account in 2 years, excluding the change in the price of oil, and demonstrated that the United States was enormously competitive in world trade once the exchange rate was put right.

There are certainly other factors that affect trade flows and trade levels, but when exchange rates change they change the price competitiveness between countries. Right now, the United States faces an enormous price disadvantage against Japan in every market—in our own market, in the Japanese market, in third markets. Mr. Morgan faces it around the world.

It is a price disadvantage, just as if a company had raised its prices, without any productivity change, by 40 or 50 percent. You lose business, and when you correct that you gain business. The data show it very clearly for the last 10 to 15 years.

So I would answer your question very differently from Mr. Mathis. I would say that exchange rate changes demonstrably improve the external balances of the countries involved. I could go into detail if you want. That is true in the German case as well.

The CHAIRMAN. Mr. Morgan, would you like to comment?

Mr. MORGAN. I would like to address Mr. Bergsten's statement, Mr. Chairman. In fact, with our own data, in 1982, the exports of our

principal Japanese competitor increased by 30 percent, and our exports decreased by 29 percent. Now, we are talking about different numbers because of the relative size of the two companies and the base sales figures to which the 30 percent and the 29 percent figures apply. But we believe these figures indicate a swing of about $400 million to $500 million of trade, if you will, between the two companies.

As I look, Mr. Chairman, at what caused that, I would observe that: Our product line was every bit as competitive in 1982 vis-a-vis the Japanese competitor in 1981; our strength of distribution was greater, I believe even more superior in 1982 than in the past. And the only thing that I am left with is the 20 percent or more price advantage which Mr. Bergsten described, because virtually all of our sales are denominated in dollars, even by both companies.

And I just have to conclude that that $400 million to $500 million swing was the result of the price advantage that they got.

Let me add another perspective. These sales would have meant 5,000 jobs additional at Caterpillar. It would have meant an additional 10,000 jobs in the ranks of our suppliers, and for a company that is in the process of having to lay off 20,000 employees because of the overall economic malaise, that $400 million to $500 million transfer represented a permanent and a significant loss, not only to our company, but also to the United States.

Mr. BERGSTEN. Mr. Chairman, if I might just add two more sentences. The numbers are so stunning that they are worth looking at. From the dollar lows of late 1978 to the recent dollar highs, the dollar actually strengthened against the yen by about 50 percent. During that same period of time, U.S. inflation exceeded Japanese inflation cumulatively by about 20 percent.

So from peak to trough, which admittedly is the extreme, but to illustrate, U.S. price competitiveness vis-a-vis Japan deteriorated by 70 percent in a 3-year period. Now, any company, as you know from your previous incarnations, which lost 70 percent of price competitiveness in 3 years would be in Chapter 11, yet that is exactly what the U.S. economy as a whole sustained against Japan, and it is therefore little wonder that we have got a major crisis on our hands.

Mr. MATHIS. Mr. Chairman, if I just might add something onto that; that is, those numbers are absolutely correct. There was a very dramatic change that began in late 1979 when U.S. interest rates rose and this was reflected in the exchange rate adjustment that followed. But high interest rates were nothing more than a symptom. I think the more fundamental problem is that the United States had failed to address inflation at an earlier period, and that the policies that were taken were taken without regard to the resulting exchange rate adjustments that did occur.

But to focus on that exchange rate change and say that is the source of the problem, I think, misses the point. I think, as Mr. Morgan said—and I agree with him fully—the point lies more deeply, I think, in the Japanese economy. It may be reflected by the exchange rate perhaps being misaligned.

The problem with the loss of U.S. export sales in the past 3 years has been distorted by the 3 years of recession globally. There has been no growth in world trade. All of our trade partners have been in recession, and the developing countries have been strapped now with financial difficulties.

I think, then, focus should be readdressed back on something that is more continuing in the nature of the Japanese management or business-government relationship that results in this more permanent loss of competitiveness, if you will, rather than just a short-term exchange rate being out of whack. Somehow the Japanese need to be shown that there are some longer term benefits to greater internationalization, and that there is a tremendous cost to the United States of supporting protectionism whether it is via capital controls or via exchange rate adjustment, or whether it is via some sort of direct trade interference.

The CHAIRMAN. Thank you very much. Mr. Morgan, do you want to comment on this? Also, I would like to ask one other question specifically to you.

Mr. MORGAN. I just wonder if I could help position the previous comment. It is fundamentally a question to me as to how much patience the business community and all the people that are dependent upon the business community for employment and things of this kind are willing to provide. It is my perspective, Mr. Chairman, and this is your area of expertise, that the mood on Capitol Hill has become very impatient toward this whole matter.

The CHAIRMAN. You are absolutely right.

Mr. MORGAN. In the corporate community, many of us—who I believe have impeccable free-trade credentials—are, I believe, the difference between the passage of local content and other restrictive forms of legislation. I believe we have made a difference when, in the past, matters of this kind have come before Congress, and we have spoken out and helped the Congress avoid their passage.

But, as I told the Japanese in a recent meeting, their friends are beginning to weaken, and I believe there will be a wholesale defection, if you will, from the process and at least the determination to lay it on the line on behalf of free and fair trade when corporate balance sheets are showing the deterioration that they are showing, and when so many employees are on layoff.

And this is the thing that worries me about not addressing this subject in terms of it being a trade issue, rather than as a pure technical issue. That is why I have no hope whatsoever that we can stand by and wait for the natural forces to take care of the problem. The economic forces are not natural. They are not free. They are not working in an uninhibited manner.

But in any event, I do not think we have time for study or for waiting for correction or other solutions of that type to occur.

The CHAIRMAN. You mentioned in your testimony that you have passed the Business Roundtable recommendations to the administration. Do you have an indication as to whether the administration is taking action? I want to touch base with them and work closely with them and coordinate our efforts with them. And also, is there any sort of joint consideration being given to this problem that you can update us on between our own Government and the Japanese Government?

Mr. MORGAN. We have been very courteously received by the administration, Mr. Chairman, on all of these various interchanges that have occurred. We have had, I believe, the attention of everybody that is important to this subject, from the President down.

I guess, feeling the urgency toward solution that I just expressed a moment ago, we would hope that perhaps a little more understand-

ing and a little more action might have occurred more rapidly. I have to be aware, however, that this is a very, very complex matter. It is hard to even articulate the more simple thoughts about it. It is very difficult to withstand the first question that you get from an adversary, whether that be a disbeliever or a person of different views in this country or Japan.

I am, however, pleased to say that the matter has never been completely turned down, without any desire or expressed willingness to continue to hear about it. There are a great many within our Government, in my view, who understand this issue very clearly.

There is always the snare, or the pitfall, if you will, of viewing it only as a technical matter and wanting to describe it in terms of economics for economics' sake. My view and training leads me to the more practical questions related to the trade competitiveness of our country and what the exchange rate problem does to competitiveness. And, of course, I'm concerned about the condition of a balance sheet, as I look after the interests of shareholders at a particular company.

The CHAIRMAN. Could you be very specific, though, in your own case? Let us make it so that it is understandable. If it goes in Peoria, so it goes in the Nation, maybe. If you could make it understandable right there, maybe we can have the country better understand it. What impact does the specific situation that we now face in the imbalance between the yen and the dollar have on your company and your operations in Peoria and other cities? What type of impact? What type of transactions are occurring or not occurring that could be rectified and changed by the recommendations you have made to the administration?

Mr. MORGAN. I see almost weekly transactions that have been lost by our company, especially in third market countries where the Japanese are our principal competitors, for only one reason, and that is price. And in a great many instances, if the yen were more highly valued, let us say by 20 percent, to pick a number, a fair amount of those transactions could have been captured by the company.

The swing in exports I mentioned before, with ours being reduced by 29 percent last year and our Japanese competitor's increasing by 30 percent is the direct effect on Caterpillar. There is no doubt in my mind but that a change in this relationship would provide instantaneous response by our company because it would affect the business that is going on today, and the deliveries that will be made in the future.

The CHAIRMAN. Thank you.

Mr. Bergsten, in your testimony, you call on the U.S. administration to face what you see as the basic inconsistency between its so-called correct devotion to free trade, and I have lauded what the President has had to say on this subject, but its incorrect devotion to laissez-faire regarding international exchange rates.

Have you seen any indication that the administration is prepared to deal with the perceived inconsistency? In what ways are they dealing with it, if they are?

Mr. BERGSTEN. I am afraid I have not seen any indications of change in policy, Mr. Chairman. There has been some modest change in rhetoric over the past few months, undoubtedly in part due to the efforts of Mr. Morgan and his colleagues. There have been a number of state-

ments by the Secretary of Treasury and other administration officials recognizing that there is a problem. Unfortunately, in the next breath, they sometimes explicitly deny that they intend to do anything about it.

There is a quote from Secretary Regan that I have footnoted in my statement which said explicitly, quoting from the New York Times of March 29,

> We should like to see a somewhat weaker dollar in order to help our exports. But that does not mean we are going to do anything about it.

That says a couple of things. It does indicate a recognition of the desirability of change. But it also indicates a real dereliction of duty in terms of doing something about a recognized problem. So I am sorry to say that I do not yet see any sign of movement, and indeed, for the reasons indicated in my statement, I think current policy is tending to make the situation worse.

The CHAIRMAN. Mr. Morgan, you have indicated a series of steps that the Japanese Government can take to ease the yen-dollar misalignment. Have the Japanese shown any indication—and I do believe the quotation that you gave from Mr. Yamashita was an extraordinarily perceptive analysis of the problem, and he is looking to the long-interests of our two countries in the way we can and must establish our relationship and work together—but have the Japanese shown any indication that they are willing to undertake the kinds of steps that you have indicated beyond what Mr. Yamashita said. And if they are not willing to do so, do you recommend the U.S. Government simply do what it can through persuasion to work with the Japanese Government in finding a basis for their taking such steps?

Mr. MORGAN. I had the opportunity, Mr. Chairman, to talk with Mr. Nakasone while he was in the United States most recently. We broached this subject in a group setting, along with several other subjects. I thought it was interesting that out of several subjects brought to his attention he chose to comment on the yen-dollar matter. That was encouraging, even though his answer was not precisely what we wanted to hear. But the fact that he commented at all, showed an awareness and a familiarity with the subject which is most important.

Subsequent to that, a group of Japanese and American businessmen met, at which Mr. Yamashita uttered the statement that I included as part of my testimony. I can tell you that since that time, and these are regular meetings, we get signals from Japan that suggest that, interestingly enough, the Japanese business community seems to have been able to get the attention of their Government, and that they are coming to a position that I would characterize as being more concerned about this matter than the U.S. side is.

One of your colleagues at the other end of the Capitol, Sam Gibbons, chairman of the Trade Subcommittee of Ways and Means, has just come back from Japan. Mr. Gibbons reported while he was in Japan that his conversation with Japanese officials indicated that they were most anxious to have this matter discussed at the economic summit at Williamsburg next month.

And so, I find that they are in some ways becoming even more responsive and more understanding than is the U.S. Government, and I believe it is out of their concern for what will happen to the world

trade situation and the potential of very unfavorable legislation that might be enacted here.

The CHAIRMAN. Thank you very much. We hope there will be some follow-through on that.

Mr. Mathis, would you care to comment—I know Mr. Morgan has already—on the GAO preliminary finding that there was no evidence that Japanese officials take deliberate actions to keep the yen low in value relative to the dollar? And if you do not agree with it, could you give some specific illustrations as to what policies the Japanese Government has followed, to keep the yen undervalued?

In fact, any one of the three of you might comment on that specific area.

Mr. MATHIS. There is no evidence that the Japanese used direct intervention to modify the exchange rate except during the last 6 months when the Japanese Government did not lower interest rates because they were sensitive about the yen becoming weaker. They wanted to try to make it stronger. There is a longer term indirect form of intervention. This does not conflict with what the GAO study found, and that is that you might say they were leaning against the wind to try to stabilize the yen.

The form of indirect intervention I tried to demonstrate by the samurai aircraft leasing scheme. Under that scheme, to correct the trade surplus position, the Japanese agreed to purchase from U.S. aircraft companies planes which in turn they then leased to other developing countries.

This generated about $1 billion in imports which helped to reduce the Japanese trade surplus position by $1 billion, but it did not generate any exports because the planes were depreciated fully during the life of the lease, so when they were actually sold to the foreign country, they were sold for $1. So, the export value was $1, whereas the import value was $1 billion.

This type of technically reacting to a problem, I think, is evidence of what I call indirect intervention. That plus what we have found in the banking community, the use of window guidance, the use of administrative guidance, where the government, the Ministry for International Trade and Industry or the Bank of Japan says, we would appreciate this type of an interest rate policy to try to support export growth, or we will shift deposits from the central bank to commercial banks at a preferred rate to try to support the growth of exports.

That type of indirect policy is all very logical in the sense that it works to achieve the self-interest of Japan of export growth and domestic economic activity, but it runs counter to accepting international responsibility on a more global basis. It is examples like these where I feel the yen has been modified or interferred with or influenced but not directly.

And that is why in my comments I would rather focus more on that indirect influence, because even if you change the exchange rate in the short term you still run into the fact that implementation of policy may offset the short-term adjustment of the exchange rate.

The CHAIRMAN. American exporters have already carried, it seems, a very heavy burden in the fight against inflation, as has been pointed out in your testimony here. We are now facing a situation where we are likely to run some very large budget deficits, and the Budget Com-

mittee and the Senate are struggling with that particular problem right now.

And if those budget deficits do continue over the next few years, it may then change the trend, which had been downward on interest rates, and cause interest rates to firm up again. Will this not be particularly, if it happens, will this not be particularly damaging once again to American exporters and therefore to jobs dependent upon exports? And is this not something we have to take into account when we try to prevent those large deficits?

Mr. BERGSTEN. You are exactly right, Mr. Chairman. American exports have been savagely hit by the overvalued dollar, which in turn relates very heavily to high interest rates here, which in turn relate to the budget deficit. The first point I suggested in my own testimony was decisive action, including, of course, by you and your colleagues here in the Congress, to get those budget deficits down, not only for domestic reasons, which are strong enough, but for these exchange rate reasons you mentioned.

Indeed, one need not go further than the recently released annual economic report of the President to get the whole story. Chapter 3 of the economic report of the President, as prepared by the Council of Economic Advisers, makes this case very clearly. It points out that the dollar has been severely overvalued and, as Marty Feldstein has put it, the result will be an unbalanced recovery of the U.S. economy. Hoping that there is a recovery, it would be an unbalanced recovery with the export sector and the industries that compete with imported goods badly disadvantaged, and not being able to take advantage of recovery because of the adverse effect on their competitiveness stemming from the exchange rate misalignment.

Thus Marty Feldstein, in a number of speeches he has made, and in the Council's annual report, pleads for a reduction in the budget deficits which would enable real interest rates to come down and permit a correction in the exchange markets.

So it is right there in the administration's own statements, testimony, public speeches, and annual economic report. What is lacking is any action to do anything about it.

The CHAIRMAN. What do you suppose the U.S. prime rate would have to be in order to achieve the 200 to 1 ratio; and what would the relative increase have to be in Japan in interest rates to achieve this?

Mr. BERGSTEN. That is a very hard one, because, as everybody has said here, a number of factors affect exchange rates at any given point in time. However, there is good evidence that changes in interest rate differentials can move the exchange markets rather quickly and rather substantially. In effect, they often overdo it. That is what is called overshooting in the markets, and sometimes in fact the rates will go further than one might like.

A group of 26 top economists from around the world met at my institute late last year to sketch out what a global recovery strategy would look like, including correcting these exchange rate misalignments. The feeling there was that we needed a change of at least 2 percentage points in U.S. interest rates to get the needed exchange rate changes. Not so incidentally, that would also help enormously get an assurance of the recovery that we all want.

If the Japanese interest rates held constant, a decline of 200 basis points in our own Treasury bill rate, Federal funds rate, et cetera, might go a long way to do the trick. The Japanese, as I indicated before, are looking to lower their interest rates in order to stimulate their own economy, and have talked about a decline of 1 or even 1½ percent in their interest rate structure.

If that occurred, then we would need something on the order of a 3 to 3½ percentage point decline in our interest rates in order to get the necessary change in the differential to promote the exchange rate correction.

That sounds like a lot, but in fact it would only take real interest rates back toward their historical levels from the stratospheric levels which now exist, so I would certainly not regard that as beyond the pale for policy.

The CHAIRMAN. Mr. Morgan, what are the most important specific ways that Japan could liberalize or facilitate inward direct investment?

Mr. MORGAN. Our prepared statement, Mr. Chairman, does include that. Let me supplement that a bit if I may and say that referencing back a few moments in terms of our communications with the administration, these suggestions that I am about to recite have been placed in the hands of Treasury Secretary Regan, and by copies to virtually all of his cabinet colleagues. But the essence of it is that restraints on the flow of yen need to be removed.

Ultimately, there should be complete internationalization of yen for natural markets, and the specificities of this in terms of possible Japanese actions are as follows. One, elimination of the yen interest rate ceilings on loans and deposits in Japan. Two, removal of restraints on the issuance of yen bonds and on short-term yen denominated bank borrowing by foreign investors.

The third point, increase the limits on certificates of deposit denominated in yen. Four, establishment of a Treasury bill market in yen open to foreign investors. Five, allowing importers to finance in yen rather than having to borrow dollars to pay for imports. Six, allowing other governments to hold more of their reserves in yen. Seven, undertaking aggressive foreign borrowing with the proceeds converted to yen. And finally, allowing purchase of yen in the forward exchange markets without restrictions.

The additional caveat is that concurrently Japan needs to take steps to liberalize foreign direct investment. The Government screening and approval process remains a major obstacle to foreign direct investment. Restrictions on stock purchases make it very difficult for a foreign entity to acquire a Japanese company.

This recipe, as it has been called, was very broadly developed by the 20 companies that are a member of the task force of the Business Roundtable which I chair. I would point out, incidentally, that Mr. Roger Anderson, chairman of Continental Illinois Bank, is a member of that task force, as are some other bankers. The other members are in services, financial, and in manufacturing enterprises. The group represents the best day in and day out experiences, in terms of reasonable, practical international-oriented business activities, that we could assemble.

I would point out that on the question, the issue of, well, what is the right value of the yen, this is a job that I readily leave to the technicians of this issue. But I do think it is very important to move the currency in a direction, especially when it is perceived that it is out of line. It reminds me of trying to determine whether you are going to hit the golf ball 5 yards to the left of the center line or 5 yards to the right of the center line when the name of the game is to get it in the fairway.

And we need to get this ball in the fairway when it is very obvious that it has strayed. And the reason you know it has strayed, in my parlance, is that when you are not able to compete or when you are at an unfair competitive disadvantage, then I think that is important to eliminate the debate over should it be 200 or 180 or 210 or 290 or whatever.

The name of the game is to get it moving in the right direction.

The CHAIRMAN. If we do not move fast enough to get it in the right direction, do you feel that we ought to give consideration, possibly through the Export-Import Bank or some other way, actually to do what some countries do—provide a direct subsidy, in this case a direct subsidy to manufacturers to encourage exports?

After all, we have devised some ways of providing incentives for exports; it is in our national interest to do so. And we do a big job of orientation. I have now held nine conferences in Illinois to orient our manufacturers there to think in terms of export markets. You always have thought about exports at Caterpillar. It has been 50 percent of your business; you saw their importance years ago. But many manufacturers have simply not seen the light and they have to reach out for it.

So, is there any mechanism that should be developed for any kind of subsidy that could be developed? And if any of you would like to comment now or comment on that for the record, you certainly can.

Mr. MORGAN. We have some thoughts, but I would let our colleagues talk here.

Mr. BERGSTEN. I would simply say, Mr. Chairman, that whenever the exchange rate is out of line as much as it is for as long as has been, you are inevitably driven in the direction of looking for offsets—import controls on that side of the ledger, and export subsidies on the other side of the ledger. Certainly the arguments for a strong Export-Import Bank or other export support programs rise very sharply, in both logic and political terms, when by dint of overall national policy we are pricing our exports out of markets and pricing imports into our markets, which is what it amounts to.

There is, however, the same technical problem that I mentioned in my testimony regarding import controls. If you put on an export subsidy which worked and had the effect of expanding our exports, holding everything else equal, that would strengthen the dollar further in the exchange markets, and perhaps even offset the benefit that had been achieved by the export subsidy.

Back in the old days, under fixed exchange rates, you could perhaps use offsetting devices—import surcharges, export subsidies of one or another type—to net out the effect of the overvalued currency on your trading companies.

But now, under flexible exchange rates, one would have to expect that the exchange rate would actually move in a way that might undermine the impact of the additional export subsidy or import control for the simple reason that, if they work, the export controls and import subsidies would improve the trade balance and everything else equal, that ought to strengthen the currency. In fact, in theoretical terms you would have a precise offset between the two movements.

You would wind up spending more Government resources on the export subsidies but not wind up with any net gain to the trade balance. That is why I oppose devices of that type, tempting as they are, because I am afraid that whatever the intention, they just would not work in the kind of financial situation we have today.

The CHAIRMAN. Do any of you feel differently?

Mr. MATHIAS. Mr. Chairman, if I might add something on that that is just a little bit different, that is that the timing right now is very precarious in the sense that the world is extremely vulnerable. We, the world in general, have been in a recession for 3 years. World trade growth has not grown for 3 years. There are going on throughout the world right now what appears to be competitive devaluations and protectionist measures in each country to try to help its own unemployment problem.

So, the timing right now in terms of what we might do might be misperceived and trigger offsetting negative actions. It is too bad we could not do this when the situation was a growing world economy.

But on the other hand, I am caught by Mr. Morgan's problem, and that is, we need to do something rather than have trade go on deteriorating, and perhaps discussion of matching schemes, export promotion schemes that are available from different countries, in other words, if Japan does this to support exports, we will match that unless Japan removes it, or if Europe does that, we will match it unless Europe corrects the situation.

It is a form of protectionism which I do not like, but perhaps that can be used as a lever to correct the situation. It is too bad that for all the effort that is put into the General Agreements on Tariff and Trade, that that agency cannot be used better to accomplish these objectives.

The CHAIRMAN. I would like to ask, because I have an unusual opportunity here, as my final question to you, not a question directly on this subject, but somewhat related to exports. I have been very concerned about the reputation of American agriculture and industry as a reliable supplier, and deeply concerned about some aspects of some of the suggestions being circulated right now, even from downtown, that would possibly detract from the reputation that we have enjoyed through the years.

We have had three setbacks every single time we have engaged in embargoes to implement foreign policy—and this is a committee that is trying to implement foreign policy. I have just felt that it is a self-defeating thing to try to implement foreign policy this way. We haven't been successful in any one of the ventures that we have made, any one of the three times we have embargoed a product. We have had not one iota of effect on foreign policy, but we have had a disastrous effect here at home.

So, my specific question would relate first, would you favor some form of contract sanctity for manufactured goods as well as agricul-

tural products—which I strongly supported on an emergency basis, the agricultural contract sanctity amendment, and urged the President to sign the bill that we adopted.

And then second, because we have a consultative group from the Soviet Union coming in June, I would like to see some action taken before then on negotiations on a 5-year grain agreement with the Soviet Union. I think that is essential and necessary now to insure that we will be a reliable supplier and we will not use export cutoffs as a means of trying to implement foreign policy.

I think we are undercutting the economy of this country, and it is not just affecting the agricultural community, it is affecting manufacturing also, in my judgment. Now, is that right or wrong, and what position would you take on the contract sanctity for manufactured goods and on a 5-year long-term agreement possibly doubling the minimum from 6 million to 12 million tons of grain. The Soviets have, after all, as of now only purchased the minimum amount. We are not the supplier of first resort. We are the supplier of last resort, with a market where we had a huge share at one point.

Mr. MORGAN. I would like to speak from the standpoint of the manufacturing sector, Mr. Chairman, and really bow out and leave to my colleagues your request for information on agricultural commodities. But as you know so well, because it has been in part because of your very much appreciated help, we have been in and out of the pipelayer business in the U.S.S.R. I cannot adequately describe to you the frustration that this has created, and the loss of jobs that has resulted at Caterpillar and its suppliers.

Those are fairly well quantifiable, but the thing that is terribly disappointing is the way in which we are regarded both as a company and as a nation by the Soviet Union. We are totally and completely unreliable in their words. And because of our use of trade as a tool of foreign policy, this attitude about the United States and its companies is becoming widespread.

We all know that favorable reputations take years and years and years to build.

Our company first had contacts with the Soviet Union in the early thirties, and we built a reputation over a period of 50 years for the kind of product and for the responsiveness and the reliability as a supplier. I have to say to you, Mr. Chairman, that all of that went down the drain, and we are back to Square One, and from the reports I hear about the treatment of our people as they go into the Soviet Union—and we have an office there, a permanent presence—it is very clear to me that they are either punishing us and or questioning our ability.

And the sad thing about it is that no company or corporate assurance can address the problem. We are deemed unreliable because of an external force over which we have virtually no control. I believe that if we are going to make any decent rate of progress at all, we are going to have to reflect that in the renewal of the Export Administration Act by talking about the sanctity of contract.

I believe it is very important for us to cause the administration, as they approach the decisionmaking on the granting of license for exports, to be confronted with evidence of the availability of foreign equivalents. Otherwise, any work, any good work that is achieved in

the next several years will all go down the drain if we cancel an existing contract, or if we, out of the belief that we are doing something from a foreign policy standpoint, deny the export of a U.S.-built product that is readily available from another supplier in another country with absolutely no impact whatsoever on the end result of the projects which the government, the Soviet Government or any other user is trying to achieve.

Mr. BERGSTEN. Mr. Chairman, I would add two dimensions to that. First, it is not only the Soviet Union in which we have become regarded as an unreliable supplier in response to these kinds of measures. Second, in 1973, when the United States put on export controls not for foreign policy reasons but putatively for anti-inflation reasons——

The CHAIRMAN. Domestic prices.

Mr. BERGSTEN. That is right. The result was to prompt the Japanese to invest $1 billion in Brazil to develop an alternative supply of soybeans which has become a major competitor cutting into our market share. When we take action for foreign policy or any other reason that makes us an unreliable supplier, our biggest markets in the industrial countries are also adversely affected, whether or not they are direct targets of the action, as they were in the pipeline case, but even if not, because they are again reminded that the United States does not put commercial objectives at the top of the priority list, but rather will ignore those objectives in pursuit of some other purpose. Therefore we are simply put down the list in terms of supply.

My Institute is just in the final stages, Mr. Chairman, of a comprehensive study of the whole question of economic sanctions applied for foreign policy purposes. We have looked at 82 cases, all of the postwar cases and the major prewar cases, to try to derive lessons that emerge from the historical record that should guide the use of policy or nonuse of policy in that area in the future. We should have that completed within the next month or so.

I would like to share it with you and the committee at that time. I think it may be helpful in pursuing the kind of discussion that you are initiating.

The CHAIRMAN. Thank you very much.

Mr. Mathis, do you want to add anything on that?

Mr. MATHIS. No.

The CHAIRMAN. Fine. I want to thank you very much. Mr. Morgan, you mentioned the Export Administration Act. I went on the Banking Committee when I first came to the Senate, and immediately went to work on that problem. It was called the Export Control Act as I remember it at the time. We changed it to the Administration Act to provide specifically that if any other—if a product line was available in other countries and it was not unique and exclusive with us, then it was ridiculous for us to be embargoing those particular items. It was a self-defeating thing. We were undercutting the economy, and that was weakening us, not strengthening us.

So, we have gone up and down on this thing, and I think we now have to once and for all solve this problem, and I think your testimony on that final question is very valuable and helpful, and I would want to use it because I have been discussing the subject with the administration in the last few days intensively.

I would like to thank you very much. We will keep the record open for 10 days so that you can amplify your comments. We may have some additional questions we would very much appreciate the opportunity to send to you. The hearing this morning has been extraordinarily helpful, and we have been given a fine agenda by our panel. Our workload is now much heavier, but I think it will be much better directed, and we will work closely with the international organizations as well as with the administration in trying to achieve an objective that is good in the long run for Japan and the United States and the entire free world.

Thank you very much.

The hearing is adjourned.

[Additional questions and answers follow:]

MR. BERGSTEN'S RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED FOR THE RECORD

Question 1. Should there be pressure on Japan to use fiscal stimulus rather than reducing interest rates (and thus complicating our task of cutting U.S. interest rates)?

Answer. As part of a coordinated global recovery strategy, Japan should emphasize fiscal tools in stimulating more rapid growth of its economy. The primary reason is that a reliance on monetary stimulus would further lower Japanese interest rates, which would tend to weaken the yen in the exchange markets and thus exacerbate the dollar-yen misalignment.

Two related points should be made. Though many Japanese worry about the current size of their budget deficit, it is actually of quite modest size when compared to the level of national savings in Japan and when the current cyclical situation is considered. Moreover, Japanese fiscal policy has moved in a contractionary direction during the last few years. These points are made and elaborated upon in "Promoting World Recovery: A Statement on Global Economic Strategy" by 26 economists from 14 countries, released by the Institute for International Economics in December 1982, among whose signers were the leading Japanese economists Saburo Okita and Hisao Kanamori.

Second, some decline in Japanese interest rates might be possible without a further weakening of the yen if U.S. interest rates were to decline by the needed 2 percentage points or so. This in turn requires significant reduction in the outyear U.S. budget deficits as well as monetary accommodation. Hence there will continue to be important interaction between U.S. and Japanese economic policy tools, and Japan's possibilities will be defined in part by what the United States does.

Question 2. (a) Shouldn't greater emphasis be placed on now liberalizing entrance of foreign direct investment into Japan?

(b) Doesn't the undervalued yen make this an advantageous time to press this issue?

Answer. Japan should fully liberalize all forms of capital inflow to Japan. There is simply no excuse for continued controls of any sort in such an advanced economy, or other policies which have the same effect. Japan rightly seeks maximum freedom of international trade and opportunity to invest abroad, and must fully reciprocate.

At the same time, we should be under no illusion that such liberalization by Japan will bring immediate correction for the yen-dollar problem. Over time, however, it would permit greater investment in Japan and thus support a strengthening of the yen—and the current undervaluation of the yen does make this a good time to press the issue. So does the current focus on the problem of industry targeting, as greater U.S. direct investment in Japan might help deal with that issue in some industries.

Question 3. Do you judge the currency misalignment seen in the overvalued dollar and relatively undervalued yen could be usefully addressed at the upcoming Williamsburg Summit meeting in late May?

Answer. The yen-dollar problem is an ideal topic for the Williamsburg Summit, for two reasons. First, it encompasses a wide range of policy considerations: macroeconomic issues (and especially the respective policy mixes of the two countries), implications for trade and trade policy, and questions of the inter-

national monetary system as well as more immediate monetary concerns. Perhaps the greatest advantage of summits is their ability to take a coordinated view of the several component parts of international economic policy, in contrast to the more normal compartmentalized approaches to trade or monetary affairs. Thus the summit should be uniquely capable of dealing with the yen-dollar issue.

Second, the other summit countries are very much involved in the issue. The yen is probably undervalued against several of the European currencies as well as against the dollar (though, as noted in my statement, there is some controversy about this). There is certainly major trade friction between Japan and the other summit countries, as well as with the United States. Hence a resolution of the problem would help deal with a multilateral, not just bilateral, issue of great importance. Moreover, the Europeans might be able to help carry out some of the needed remedial measures, such as joint intervention to strengthen the yen in the exchange markets.

[Whereupon, at 1:05 p.m., the committee adjourned, subject to call of the Chair.]

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